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ABSTRACT

This report focuses on state and local taxation in the state of Kentucky. It looks into what "the ideal" tax system looks like and how Kentucky's system compares, whether the current system will provide adequate revenue for the long-term, whether the tax system is efficient, how fair and equitable the tax system is, and whether the state is competitive with respect to the taxation of business. There are eight chapters: (1) "Tax Reform in Kentucky: Principles and Practice"; (2) "Recent Trends in Kentucky State and Local Tax Policy"; (3) "Sales Taxation in Kentucky: Problems and Prospects"; (4) "Tax Equity in Kentucky: Family Tax Burdens and the Question of Fairness"; (5) "Business Taxes in Kentucky"; (6) "Local Government Finances in Kentucky"; (7) "The Impetus for Tax Modernization: Economic, Demographic, and Political Change"; and (8) "Tax Reform: Review and Perspective." A glossary of tax-related terms is included after the summary, and a CD-ROM providing fully indexed access to reports on Kentucky state and local finance is included on the back cover. (Contains 48 figures and 26 tables.) (RT)

FINANCING

STATE AND LOCAL GOVERNMENT

*Future Challenges
and Opportunities*

By
David E. Wildasin
Michael T. Childress
Merl Hackbart
Lawrence K. Lynch
Charles W. Martie

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LONG TERM POLICY RESEARCH CENTER

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PREFACE

As part of its mission to advise and inform the Governor, the General Assembly, and the public about the long-term implications of policies, the Kentucky Long-Term Policy Research Center, in conjunction with the University of Kentucky Martin School of Public Policy and Administration, reports here on tax policy in the Commonwealth. This collection of articles by some of the state's leading experts considers the underlying principles and purposes of tax systems and examines the Commonwealth's overall tax structure in light of these, considering the adequacy of our current system over the long term, its fairness to families and businesses, and its competitiveness. This report also explores the implications of economic and demographic trends for the future and the challenges and opportunities that efforts to reform and modernize our tax system face in view of their history here and, more recently, in other states. Whether read in its entirety or as stand-alone chapters that address discrete topics, policymakers at every level and all who are interested in and concerned about the fiscal future of the Commonwealth will likely find information of interest in this report.

KENTUCKY

LONG-TERM POLICY RESEARCH CENTER

The Kentucky Long-Term Policy Research Center was created by the General Assembly in 1992 to bring a broader context to the decisionmaking process. The Center's mission is to illuminate the long-range implications of current policies, emerging issues, and trends influencing the Commonwealth's future. The Center has a responsibility to identify and study issues of long-term significance to the Commonwealth and to serve as a mechanism for coordinating resources and groups to focus on long-range planning.

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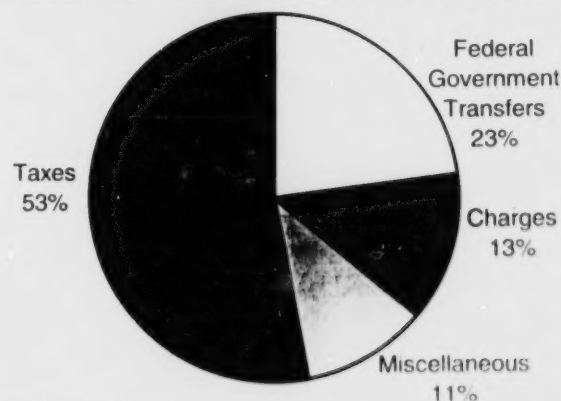
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SUMMARY

Kentucky state and local governments' general revenue was approximately \$18.4 billion during the 1998-99 fiscal year. Of this amount, just over half, or about 53 percent, came from taxes (i.e., sales, income, occupational, or property). As shown in Figure S.1, the other 47 percent came from the federal government (i.e., intergovernmental transfers), charges (e.g., tuition), or some other source (e.g., interest earnings).¹ This report touches on many of these areas, but its principal focus is on state and local *taxation*. And because the topic of state and local taxation is too vast and complex for a single study or volume to examine every facet, we have focused our inquiry on the following questions:

- What does "the ideal" tax system look like and how does Kentucky's system compare?
- Will our current system provide *adequate* revenue for the long-term?
- Is the tax system *efficient*?
- How *fair* or *equitable* is the tax system? and,
- Are we *competitive* with respect to the taxation of business?

FIGURE S.1
Distribution of Kentucky State and Local Government General Revenue, 1998-99



Source: US Census Bureau

¹ U.S. Census Bureau, *Kentucky State & Local Government Finances by Level of Government: 1998-99* <<http://www.census.gov/govs/estimate/9918ky.html>> 4 Oct. 2001.

The best tax system is wholly dependent upon the policy objectives and the socioeconomic context; consequently, there is no single ideal system. Nonetheless, there are good tax principles to which we should adhere but frequently have not. Over the years, a number of incremental changes and special tax code exemptions have reduced compliance with long-standing, "good" tax principles, degraded the efficiency of the system, and reduced the elasticity of several taxes, especially the sales tax. Other economic changes such as the growth of remote sales and other structural economic changes have further exacerbated the ability of the state's revenue to grow in proportion to the expansion of Kentucky's economy—a reasonable expectation if Kentucky state and local governments are to provide the educational and other services demanded by Kentucky's citizens. These deficiencies have been growing over time and cause us to question the long-term adequacy of Kentucky's system of state and local taxation. And while we find that the overall system is not egregiously regressive or unfair, the system could be made more progressive by lightening the tax burden on the working poor, but at a significant cost. Finally, we show that Kentucky's business taxes are essentially competitive with neighboring states.

THE IDEAL SYSTEM

Existing tax policies in Kentucky, as well as everywhere else in the world, reflect a tug of war among different policy objectives; thus, there is no uniquely "ideal" tax structure. Nevertheless, tax policy experts generally agree that a good state and local tax system should: (1) provide appropriate (i.e., adequate) and timely revenues; (2) distribute burdens equitably (i.e., fair); (3) promote economic efficiency and economic growth, including achieving a fiscal system that is competitive with those of other states; (4) be easily administered; and (5) ensure accountability (i.e., transparency). Unfortunately, many of the marginal changes to Kentucky's tax structure over the last several decades were enacted with little consideration of their impact on the overall fairness, neutrality, simplicity, adequacy, or competitiveness of the Kentucky tax structure. Understanding the tradeoffs between the principles and adhering to them

We can do a better job in tax policy analysis and formulation if we clarify our thinking about fundamental goals and tradeoffs among them.

is important for Kentucky to have a good system of state and local taxation. We can do a better job in tax policy analysis and formulation if we clarify our thinking about fundamental goals and tradeoffs among them. In short, we can elevate the dialogue surrounding tax modernization and increase the understanding of the tax structure, both among state and local policymakers and citizens at large, by carefully evaluating tax changes in the context of the principles of a good tax system.

ADEQUACY

The issue of adequacy has both a short- and long-term component. We have focused our analysis on the long-term adequacy of the tax system, but recent events have focused the attention of policymakers and citizens on the short-term outlook. Budgetary demands have become much more acute in Kentucky as a result of the approximate \$713 million in budget adjustments this biennium.² Moreover, others have estimated that the tax-cutting actions at the federal level this year will have a net negative impact on Kentucky, primarily due to the changes in the estate tax, of over \$40 million per year.³ And current drafts of the federal economic stimulus package include changes in corporate taxes that will reduce Kentucky's corporate income taxes by more than \$100 million per year in the first three years of the package.⁴ Further, the National Conference of State Legislatures recently identified Kentucky and 14 other states as being "... in worse fiscal condition than others because they are being hit both on the spending and revenue sides of their budgets."⁵ And we know that one of the rating agencies that assesses the fiscal health and credit worthiness of the state, Standard & Poor's, has placed a "negative outlook" on Kentucky's credit rating. This negative outlook amounts to a warning to adopt a structurally balanced budget (i.e., recurring revenues that match recurring expenditures) or face a downgrade in the state's credit rating.⁶

Over the long term, a number of economic, demographic, and political trends suggest that Kentucky's state and local system of revenue gathering might not be adequate. Individuals are receiving a greater portion of their income from nontaxable sources. Consumers are purchasing an increasing amount of untaxed services and avoiding the use tax through Internet or catalog purchases. Our population is aging at a faster rate than most states, and this will likely reduce some state and local tax receipts because elderly households tend to have lower consumer expenditures and to spend less on taxed items. Also, Kentucky state income tax is not paid on Social Security income or the first \$35,000 of private pension income.

Since Kentucky's state and local fiscal structure relies heavily on income and sales taxes, we will begin to feel the effect of these long-term structural economic and demographic changes before many other states. Kentucky (state and local combined) receives about 69 percent of its tax revenue from the income and sales

Over the long term, a number of economic, demographic, and political trends suggest that Kentucky's state and local system of revenue gathering might not be adequate.

² Office of the Governor, "Governor manages budget shortfall, maintains education funding," press release, 26 Oct. 2001.

³ Mary E. Lassiter, Deputy Executive Director of the Governor's Office for Policy Research and Special Assistant to the State Budget Director, e-mail to the author, 27 Nov. 2001.

⁴ Lassiter.

⁵ National Conference of State Legislatures, *State Fiscal Outlook for FY 2002: October Update*, 31 Oct. 2001, <<http://www.ncsl.org/programs/fiscal/sfo2001.htm>>, 2 Nov. 2001.

⁶ Lassiter.

tax—the fifth highest percentage in a ranking of all states. Meanwhile, the U.S. average is closer to 58 percent.

Additional analysis could be conducted to determine whether more reliance on the property tax is warranted, and if so, how best to achieve it in the context of House Bill 44 (HB 44). Under the provisions of HB 44, the property tax rate imposed by a local government—a county, municipality, school district, or other special district—cannot normally be set at a level that would result in an increase in total revenue by more than 4 percent above the revenue collected during the preceding year. Some argue that HB 44 imposes a significant limitation on the ability of local governments in Kentucky to raise revenue, but we find the evidence somewhat mixed. More detailed and comprehensive analysis, including the systematic collection of data on property tax revenue growth for all local governments, would be of great value in determining the impact of HB 44 on local governments and in gauging the possible consequences of its revision or rescission.

EFFICIENCY

Most public finance and tax policy experts agree that taxes should have a minimal or neutral effect on the behavior of consumers, and a tax that satisfies this criterion is said to promote economic efficiency. Yet, almost all taxes cause some loss of economic efficiency. As a practical matter, then, the challenge for economic policy is to limit the extent of the efficiency losses. As a general principle, the efficiency losses from a tax are modest and even negligible if the tax rate is very low but rise rapidly as the tax rate increases. Another important principle is that taxes cause greater efficiency losses when levied on goods or services for which the level of consumption is very sensitive to price. For example, the

The issue of base broadening is one that warrants close attention in the context of Kentucky's sales tax.

consumption of movies is more price-sensitive than the consumption of food, and thus a 5 percent tax on the former would cause a greater efficiency loss per dollar of revenue collected than a 5 percent tax on food. These considerations generally argue in favor of broad-based taxes, which allow a given amount of revenue to be collected at a lower tax rate, and which,

because of their inclusiveness, limit the opportunities for taxpayers to switch from taxed to untaxed activities. A general sales tax would therefore be preferred, on efficiency grounds, to a tax on the consumption of just one commodity category, such as apparel. A tax on all earnings would be preferred on efficiency grounds to a tax limited to earnings from only one type of work, such as agriculture. The term "neutrality" is often used to characterize a tax system that does not favor particular kinds of economic activity (such as employment, consumption, or investment) over another. A "neutral" tax will apply uniformly to a broad set of activities, making it possible to collect revenue at a lower rate of taxation. As will be discussed further, the issue of "base broadening" is one that warrants close attention in the context of Kentucky's sales tax.

The sales and use tax is one of the major revenue sources for Kentucky, as it is for many states. This tax is imposed on tangible goods but not on intangibles such as services. In this important respect, the tax is far from a comprehensive tax on household consumption. Furthermore, it appears that a substantial portion of sales tax revenue derives from the taxation of transactions between firms. This compounds the tax burden on some categories of goods, as they are taxed at multiple stages in the production process. This system creates high cumulative effective tax rates on some goods and very low tax rates on others. Reforms that would avoid multiple taxation of some goods while including currently untaxed categories of consumption would likely improve the efficiency of the tax system and bring the sales tax closer to a uniform tax on all consumption. However, avoiding the taxation of intermediate goods might necessitate significant changes in sales tax administration, a step not to be taken without careful consideration of administrative and compliance costs.

EQUITY

Most people agree that a fair tax system is one that treats people in similar situations similarly—a concept known as horizontal equity. At the same time, most people agree that the tax system should treat people of different economic means differently—a concept known as vertical equity. The principle of vertical equity is often used to justify income taxes at proportional or progressive rates. Under a proportional income tax, all households pay the same fraction of income in taxes, so higher-income households pay higher taxes than those with lower incomes. In a progressive system, individuals or households with higher incomes face higher tax *rates* and their tax burdens therefore are higher than those on lower-income households both because their incomes are higher and because they pay a larger share of their income in taxes. On the other hand, a “regressive” system is one in which individuals or households with lower incomes pay a higher *fraction* of their incomes in taxes compared to those with higher incomes, even if they pay less in total. (For example, a flat-rate charge for renewal of vehicle licenses, which requires all vehicle owners to pay the same amount, would be regressively distributed relative to income.)

Some have questioned the fairness or equity of Kentucky's tax structure, especially for the working poor, but the interpretation of fairness is largely subjective. Nevertheless, some broad principles emerge. Kentucky's state and local tax system carves out significant exemptions on necessities and provides income tax credits for the very poor. The tax burden is fairly proportional over most income ranges except the upper-income levels, where it is somewhat regressive. In recent years, the legislature has enacted indexing provisions in the standard deduction and in the pension exclusion, but the impact on the working poor has been minimal.

Addressing inflation, which has robbed Kentucky's income tax of its progressivity, would enhance vertical equity.

The equity of tax systems changes over time because of incremental exemptions, rate changes, court-driven exclusions, and exemptions and deductions that were not indexed to inflation. In fact, some of the strongest criticism of Kentucky's tax code concerns its failure to adjust to changing costs of living. Rate classes, low-income credit thresholds, and personal credits have largely remained at their original levels. Addressing inflation, which has robbed Kentucky's income tax of its progressivity, would enhance vertical equity. The current rate brackets, rising from 2 percent on the first \$3,000 of taxable income to 6 percent of income above \$8,000, are as they were in 1950 when per capita income in Kentucky was \$990. The effect has been to remove a large degree of progressivity from the tax. The low-income credit, established in 1990, remedied some of this problem, but the failure to index its thresholds has weakened its effect over time.

Indeed, we calculate that if income tax brackets, credits, and the standard deduction had been regularly adjusted to reflect changes in the Consumer Price Index (CPI), the 6 percent marginal tax rate would start at \$57,000 rather than the current \$8,000. Families with taxable income less than \$35,000 would face only a 4 percent marginal rate. Furthermore, the standard deduction would be \$2,700 larger, and a family of four would receive \$380 more in personal tax credits. However, we also calculate the potential cost of indexing to the CPI, and it is enormous. There are numerous scenarios one could examine, and most result in the loss of significant revenue and/or a rather considerable shifting of the tax burden to higher-income families. The current tax structure can be made more equitable but at a cost. By shifting the burden to higher-income households, it might have the unintended consequence of discouraging entrepreneurs or business executives (with high incomes) to relocate or remain in Kentucky, an important policy objective for the Commonwealth.

COMPETITIVENESS

The impact of taxes on Kentucky's economic development is an important consideration. One element of this pertains to how competitive our tax system is compared to other states. Ideally, of course, our goal is to avoid tax burdens that significantly exceed those of neighboring states. Is Kentucky's tax structure competitive, or do we discourage capital investment in Kentucky with high business taxes? Two recent studies of business tax burdens came to opposite conclusions: a Barents Group analysis found that Kentucky has average business tax burdens and higher-than-average individual tax burdens, but a joint study by the University of Kentucky Center for Business and Economic

Kentucky's business taxes are competitive when compared to neighboring states.

Research and the University of Louisville College of Business and Public Administration found that Kentucky has above-average business tax burdens.

We find that, in general, Kentucky's business taxes are competitive when compared to neighboring states. Kentucky's *general* business taxes per \$100 of private gross state product place it fifth highest among the eight states in our region while our rank for *comprehensive* business taxes places us at third highest.

Consequently, while there might be reasons to lessen the tax burden on certain industries, we see no merit to the argument that business taxes need to be cut across the board on competitive grounds.

BACK TO PRINCIPLES

There are many changes one could make to Kentucky's system of state and local taxation that would enhance one or more of the principles outlined above. However, many of these changes would simultaneously detract from one or more of the other principles. Therefore, it is important for policymakers and citizens to be cognizant of these tradeoffs, so decisions can be made to enhance one principle while recognizing the potential negative impact it might have on the others.

Perhaps the best way to achieve comprehensive tax modernization in the absence of a major catalyst is to make frequent small improvements. Indeed, our history with tax reform suggests that policymakers prefer to revise state tax structures incrementally, so changes in state revenues are small and impacts on tax-paying groups are marginal. With small changes, state revenue and tax impacts may be easier to determine, and fluctuations in state revenue streams from the direct and behavioral impacts of tax changes may be limited. The tendency for incremental or gradual tax policy change does not necessarily doom comprehensive state tax reform. Rather, it may suggest that comprehensive reform may have a greater chance for success, absent a major "driving force or event," if reform goals are set and incremental changes toward those goals are enacted over time.

GLOSSARY

Adjusted Gross Income. An income concept defined by tax law—consists of taxable sources of income (net of specific adjustments) received by individuals as reported on IRS Form 1040. It includes wages and salaries, income from rent, self-employment earnings, dividends, interest, pension benefit payments, net gains from the sale of assets, and other types of income not expressly exempt from taxation.

Benefits Principle (or Benefits-Received Principle). This independent normative principle states that the beneficiaries of a particular government-spending program should have to pay for it.

Consumption Tax. A tax on the value of all goods and services consumed within a period of time.

Deadweight Loss. A loss of welfare above and beyond the tax revenues collected. The price distortions caused by the imposition of a tax discourage transactions that would have otherwise taken place in its absence. Some of the welfare attributable to these transactions is recaptured in the form of tax revenue, but not all of it and this is the loss to society known as deadweight loss.

Effective Tax Rate. The actual tax rate applicable to a particular situation, which usually differs from the rate levied by statute. For instance with the personal income tax, the effective tax rate is the proportion of total income paid, which may be different from the statutory rate after all adjustments to income have been made (see Adjusted Gross Income).

Horizontal Equity. In a tax system horizontal equity means that people of similar means are taxed similarly.

House Bill 44 (HB 44). Under the provisions of this statute, which was enacted in 1979, the property tax imposed by a local government cannot normally be set at a level that would result in an increase in total revenue by more than 4 percent above the revenue collected during the previous year.

Impact. A reference to the person or persons who are required by statute to pay the tax, as opposed to the incidence of the tax, which refers to those ultimately bearing the burden of the tax. Someone who rents a dwelling may bear some of the *incidence* of the property tax although the landlord bears the *impact*.

Incidence. A reference to the person or persons who ultimately bear the burden of a tax, as opposed to the *impact* of the tax, which refers to the taxpayer who is required by statute to pay it and who may pass some or all of the burden to someone else.

Marginal Tax Rate. The change in taxes paid with respect to a change in income.

Own-Source Revenue. Revenue a government raises by means of its own legislation or other action, as opposed to grants-in-aid or transfers from another govern-

ment. State taxes are an own-source revenue for the state that collects them, as opposed to federal Medicaid reimbursements to the state.

Poll Tax. A capital tax levied equally on every adult in the community.

Progressivity. The degree to which a tax imposes a proportionately heavier burden on high income people than on low income people. The federal personal income tax is generally regarded as a progressive tax.

Regressive Tax. A tax that imposes a proportionately heavier burden on low income people than high-income people as a share of their incomes. Sales taxes on groceries are regressive because people spend roughly similar amounts on groceries regardless of income; this means that a larger share of poor people's income goes for groceries.

Tax Shifting. The extent to which impact and incidence differ.

Turnover Tax. A tax which has as its base the total value of sales at each level of production.

Use Tax. Also frequently referred to as "compensating use tax." A tax generally levied at the same rate and on the same base as the sales tax on the use, consumption, or storage of goods and services in a state (and, where applicable, locality). A compensating use tax is required to be paid by customers who purchase goods outside the state and then bring them into the state for use, storage, etc. States are also beginning to levy use taxes on services that are obtained from out-of-state providers but consumed in state.

Value-Added Tax. A levy imposed on business at all levels of the manufacture and production of a good or service and based on the increase in price, or value, provided by each level.

Vertical Equity. Refers to the way that households or taxpayers of different incomes or levels of resources are treated by a program or tax. Evaluations of a tax as either progressive, proportional, or regressive are measurements of its vertical equity.

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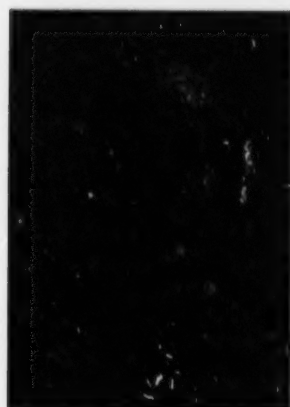


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TAX REFORM IN KENTUCKY

Principles and Practice

By David E. Wildasin*

Tax policy usually reflects an uneasy compromise among conflicting objectives, no one of which can be the sole determinant of policy or of policy reforms. Efficiency and equity (or fairness) in taxation are two fundamental economic criteria by which tax reforms can be usefully evaluated. These are complex and many-faceted concepts that include many other important criteria for policy evaluation, such as simplicity and competitiveness. Tax reform proposals almost always necessitate difficult tradeoffs between efficiency and equity.

Tax policy is inevitably a contentious subject. Oliver Wendell Holmes famously declared that "taxes are what we pay for a civilized society," a lofty sentiment indeed, and perhaps one that is widely shared. But most taxpayers nonetheless seem to feel that the cause of civilization might be still further advanced if its price were distributed somewhat differently, usually in any direction but theirs. Senator Russell Long, a veteran tax



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legislator, summed it up this way: "Tax reform means, 'don't tax you, don't tax me, tax that fellow behind the tree.'" Moral and ethical principles are frequently invoked in tax reform debates, with advocates strenuously asserting the importance of "fairness" and "equity" in taxation—discovering, remarkably enough, that adherence to these moral principles usually necessitates "taxing the fellow behind the tree."

Fairness in taxation is undoubtedly important to all citizens, and certainly no branch of government seeks an inequitable distribution of tax burdens. Meaningful discussion of tax reform must begin with a recognition, however, that there is wide disagreement about the meaning of "fairness" or "equity." It must also begin with a recognition that the search for better tax policy always involves the balancing of competing principles, of which equity or fairness is one but never the only one. This balancing is no easy task, but constructive public discourse can be advanced by an awareness that tax policy does involve tradeoffs, and that policy-makers, and the citizens that they represent, must make choices among competing goals.

Economists have been grappling with the problem of taxation at least since the time of Adam Smith's *Wealth of Nations* (1776), and certain perspectives have gradually evolved during the past two centuries of attempts to systematize the analysis of tax policy.⁷ Perhaps the most important perspective that economists bring to bear is that public policies, including tax policy, should be evaluated in terms of their impact on economic welfare, that is, the economic well-being of the members of society. Taxes harm the economic well-being of those who bear their burden, but some methods of raising revenue cause more harm than others. To quote another famous justice of the Supreme Court, John Marshall, "The power to tax involves the power to destroy." As Justice Marshall saw clearly, taxes affect behavior. An industry, an occupational category, the economy of a region, and even the economy of an entire state can be hampered, discouraged, even destroyed by taxation because taxes create economic incentives that generally tend to discourage the taxed activity. These incentives sometimes work in a very direct and obvious fashion, as, for example, when taxes on particular items of consumption such as luxury goods, tobacco products, or alcohol cause consumers to reduce their purchases of taxed commodities—or to obtain those commodities from untaxed sources such as out-of-state suppliers. Sometimes the incentives are much less direct, as, for example, when taxes on energy cause an increase in the cost of production for certain industries, whose outputs then become more costly, resulting—perhaps through several further stages in the production process—in higher prices for goods or services purchased by households. The adjustment of economic behavior in response to tax and other fiscal incentives may occur rapidly in some cases and quite slowly in other cases, but at whatever rate they proceed and however indirect they may be, the responses of producers and consumers to changes in tax policy play a crucial role in determining the ultimate impact of tax

⁷ The discussion in this and the following chapters relies heavily on many important scholarly and policy-analytic studies by many researchers in Kentucky and throughout the world. This work is aimed at a general audience, and citations to previous work are minimized in the interest of readability.

policy both on the *allocation of resources* in the economy (that is, the levels of consumption and production of different goods and services) and on the *economic incidence* of taxes, that is, the distribution of the real burden of the tax system.

TAXES AND ECONOMIC EFFICIENCY

The free play of market forces tends to drive the allocation of resources in ways that reflect both the costs of production of different goods and services—the value of the labor, capital, land, raw materials, and other inputs used in production—and the valuation of these goods and services by consumers—the amount that consumers are willing and able to pay for them. The search for profits by firms leads them to attempt to match production with consumer preferences and to find the least costly ways of satisfying consumer wants. The search by consumers for desired goods and services at low prices, the search by workers for satisfying and remunerative employment, and the search by investors for profitable outlets for new investment are all examples of economic behavior through which markets mediate the complex process of allocating resources and, in the process, balancing the benefits and costs of different possible resource allocations. Markets do not always function perfectly, and government policies, including tax policies, are sometimes needed to ensure certain goods and services are adequately provided.⁸ As a general proposition, however, freely functioning markets work to achieve an *efficient* allocation of resources, that is, one that promotes economic welfare by ensuring that the limited productive capacity of the economy is utilized in the satisfaction of the preferences of households. When taxes affect economic incentives and thus economic behavior, resource allocation becomes dependent not only on the underlying costs of production of goods and services and on the valuation of goods and services by households, but on the tax implications of economic decisions. Virtually all taxes do alter economic incentives, and thus give rise to economic inefficiencies. An important objective of tax policy should be to limit the economic harm that the tax system causes through these inefficiencies.

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Several examples can help to illustrate the kinds of inefficiencies that taxes can create. A tax on a household's income, such as Kentucky's personal income tax, creates fiscal incentives for taxpayers to alter their behavior. An income tax creates incentives for taxpayers to have less taxable income, which they can do by

⁸ For example, taxes can help to discourage pollution, excessive congestion of highways, and other forms of economic behavior for which markets do not force polluters, road users, etc. to take into account the costs imposed on the rest of society by their behavior. In such cases of so-called "negative externalities," the discouraging effect of taxes may be precisely what is needed to improve economic incentives.

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working less and having less earned income, by saving less and having less interest, dividend, and other forms of income derived from the accumulation of wealth, or by receiving income in tax-preferred or tax-sheltered forms such as untaxed fringe benefits, tax-sheltered retirement savings, or tax-preferred capital gains, to name only a few possibilities. Kentucky's sales tax does not fall equally on all categories of consumption, as described in Chapter 3, and it thus creates incentives favoring certain patterns of consumption over others. Because it reduces the effective purchasing power of household incomes, it also discourages work effort in much the same way as the income tax, even though it does not actually tax earnings directly or explicitly. Local property taxes increase the cost of residential housing, both for homeowners that pay these taxes directly and for renters who absorb some portion of the tax in the form of higher rents demanded by landlords who are liable for property taxes. Property taxes on commercial and industrial property affect the profitability of investment, the amount of employment, and the output of goods and services; business income taxes affect investment and employment incentives, and so forth.

Most state and local taxes are *location-contingent*, that is, they must be paid by taxpayers located within a taxing jurisdiction but are not paid by those outside. Kentuckians pay the state's personal income tax, but could avoid this tax if they lived outside of the state. For the most part, they pay the state's sales tax because many of their purchases occur within the state; households residing outside of the state may pay some of Kentucky's sales tax if they happen to engage in purchases here, but nonresidents generally pay relatively little of Kentucky's sales tax. A household or business can avoid the property tax collected by a particular municipality, country, or school district by locating in a different jurisdiction either within the state, in another state, or even in a different country. A business may build facilities and hire workers in Kentucky in order to sell goods and services to the state's residents or for export, or it may instead locate in another state (or country), and its location will affect whether it pays taxes to the state. Location-contingent taxes affect the incentives of households and firms to locate in Kentucky, and in particular localities within Kentucky.⁹ The phrase "fiscal competition" (or "tax competition") is often used to describe the fact that individual states and localities "compete" for productive, mobile resources with other jurisdictions, and that taxes (along with other policies, including the provision of public services financed by taxes) help to determine whether and what types of investment, workers, and other resources are drawn to or repelled by these units of government. Concerns about the "competitiveness" of state and local tax systems arise from a recognition that taxes affect the locational dimensions of economic behavior—one of the many incentive effects that arise from taxes.

Almost all taxes cause some loss of economic efficiency. As a practical matter, then, the challenge for economic policy is to limit the extent of the efficiency

⁹ Are any taxes *not* location-contingent? Yes, because some taxes are assessed against resources that cannot move from one place to another. Leading examples would be taxes on land and natural resources (including, for example, taxation of mineral resources like coal). The owner of a mineral deposit or parcel of land can escape tax.

losses (sometimes called the "excess burden" or "deadweight loss" of taxation). As a general principle, the efficiency losses from a tax are modest and even negligible if the tax rate is very low, but rise rapidly as the tax rate increases.¹⁰ Another important principle is that taxes cause greater efficiency losses when levied on goods or services for which the level of consumption is very sensitive to price. For example, the consumption of movies is more price-sensitive than the consumption of food, and thus a 5 percent tax on the former would cause a greater efficiency loss, per dollar of revenue collected, than a 5 percent tax on food.¹¹ These considerations generally argue in favor of broad-based taxes, which allow a given amount of revenue to be collected at a lower tax rate, and which, because of their inclusiveness, limit the opportunities for taxpayers to switch away from taxed toward untaxed activities. A general sales tax would therefore be preferred, on efficiency grounds, to a tax on the consumption of just one commodity category, such as apparel. A tax on all earnings would be preferred on efficiency grounds to a tax limited to earnings from only one type of work, such as agriculture. The term "neutrality" is often used to characterize a tax system that does not favor particular kinds of economic activity (such as employment, consumption, or investment) over another. A "neutral" tax will apply uniformly to a broad set of activities, making it possible to collect revenue at a lower rate of taxation.¹² As will be discussed further below, the issue of "base broadening" is one that warrants close attention in the context of Kentucky's sales tax.

TAXATION AND EQUITY

As observed at the outset, differing conceptions of fairness or equity pervade tax policy debates. Several distinct notions frequently arise in this context.

ABILITY TO PAY

According to one equity principle, a fair tax system is one that distributes tax burdens in accordance with *ability to pay*. Typically, "ability to pay" is interpreted as a household's economic well-being, measured by the amount of income that a household has or the amount of consumption that it undertakes, and the ability-to-

¹⁰ According to one simple rule of thumb, the efficiency loss rises with the square of the tax rate. This means, for example, that doubling the rate of tax causes the efficiency loss to quadruple.

¹¹ The logic of this statement is easy to understand. The efficiency losses from taxation result from its effect on the amounts of goods and services produced and consumed. When these amounts are not much affected by prices, taxes have a modest efficiency impact. For this reason, the efficiency losses from taxation are often larger in the long run than in the short run. For example, in the short run, a gasoline tax will affect gasoline consumption mainly through its impact on the amount of transportation undertaken with the existing vehicle fleet in carrying out customary travel. In the long run, a tax on gasoline would induce consumers to switch to more fuel-efficient vehicles and to alter travel patterns, for example, by living closer to work (or working closer to home) or by switching to public transportation.

¹² A truly efficient tax system would impose higher rates of taxation on those goods and services for which consumption is price-insensitive, but in practice it is difficult to obtain the information needed to implement this principle, and for that reason many economists favor a relatively uniform rate of taxation on efficiency grounds.

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pay principle would require that a higher level of taxes fall on households with greater ability to pay. A proportional income tax could be viewed as generally compliant with this principle because a household with, say, twice as much income, would pay twice as much in taxes. A progressive income tax, under which a household with twice as much income would pay *more* than twice as much in taxes, could be argued to satisfy the ability-to-pay principle as well, or perhaps even more so. On the other hand, progressivity or proportionality are not required by the ability-to-pay principle: even with a somewhat *regressive* income tax—one under which a household with twice as much income would pay, say, one and one half times as much in taxes—the tax system could still attach higher tax burdens to households with higher ability to pay.

Aside from the question of how tax rates should vary with ability to pay, there is a real question as to whether income is the best measure of ability to pay for a household, and the measurement of income itself is far from straightforward. Should wealth (the net worth of a household, that is, the value of its assets net of any liabilities) be considered in determining a household's ability to pay, for example? Households with high levels of wealth tend, on average, to have high levels of income, but the two are certainly not perfectly correlated. A farmer may own a substantial amount of land and other assets but in any one year may have high income, low income, or even negative income (i.e., a net loss). A young family with two earners may have high income but little accumulated wealth, whereas a retired couple or elderly widow or widower may have no earnings but a substantial amount of accumulated assets, including perhaps a house with little or no remaining mortgage debt. Taxes on real property, which are commonly used by local governments, including those in Kentucky, are not true wealth taxes since they are based only on one type of wealth (real property) and are assessed on the gross value of real property, not its value net of outstanding debt obligations. One could still argue, however, that the tax on real property does on average tend to impose higher tax burdens on households with greater ability to pay.

As an alternative to using income or wealth as a measure of ability to pay, many economists would prefer to use consumption, that is, the value of all goods and services consumed within a period of time. The retail sales tax is one example of a tax that is (or at least could be) closely related to consumption. Consumption taxes are often said to be "regressive" because the amount of income that is spent on consumption tends to diminish as a household's income rises. If income is viewed as the correct measure of ability to pay, then consumption taxes are only imperfect approximations of ability to pay. It should be noted, however, that the personal income tax in Kentucky, like the federal income tax to which it is very closely related, actually has many features that make it like a consumption tax—so much so that most economists view the personal income tax, as presently implemented in the United States and in many other countries, as a "hybrid" form of taxation, a mix between a pure income tax and a pure consumption tax.¹³ And the

¹³ A detailed explanation of this point, which has several facets, goes beyond the scope of the present report. As one important illustration, however, one need only remember that much retirement savings is tax-sheltered. By using 401(k) plans, IRAs, Keogh plans, SEPs, traditional pension plans, and other

ethical basis for using consumption rather than income as an indicator of ability to pay, if debatable, is by no means indefensible.

It is important to note that the ability-to-pay principle concerns the distribution of tax burdens among *individuals or families*, that is, to "natural persons." Businesses, properly speaking, have *no* ability to pay, even though they may be regarded as "persons" under the law. Business activities *affect* the ability to pay of natural persons, for example by creating real income for their owners, for their employees, or for consumers. As a practical matter of tax implementation, it may be very difficult to determine how much income a corporation is producing for its shareholders if its profits are not distributed in the form of dividends, and households with high ability to pay might escape appropriate tax burdens if corporate income is not separately subject to taxation. A corporation income tax may offer a practicable if imperfect means by which the tax system can reach some of the otherwise lightly-taxed income of *individuals* and it may thus contribute to an improvement in the distribution of tax burdens in accordance with ability to pay.¹⁴ But under this view, the taxation of corporations and other businesses should be seen as one component of the overall fiscal system that imposes tax burdens on people. Businesses as such can never truly *bear* any tax burdens, they can only *distribute* tax burdens to natural persons.

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BENEFIT TAXATION

Rather than attempting to relate tax burdens to ability to pay, one might take quite a different perspective on fairness in taxation by arguing that taxes should be related to the benefits that governments provide to taxpayers. This concept of fairness is related to the notion of "fair exchange," as in commercial transactions: it is fair to tax those who, in exchange, receive something of value from the government.

As a corollary to the benefit principle, it would appear that those who benefit more from government should pay more in taxes. A practical obstacle to the application of this principle, however, is the difficulty of measuring the benefits re-

retirement-savings vehicles, younger taxpayers can shelter a portion of their income—a part that they save, rather than consume—until later in life, when they receive distributions from their savings plans. These distributions finance consumption during retirement. Thus, at least a portion of income not consumed when young escapes income taxation, while it is subject to taxation when it is consumed later in life, effectively converting the "income" tax into a tax on consumption. This observation incidentally illustrates the fact that one must not attach too much significance to the labels conventionally attached to taxes: calling a tax an "income" tax does not necessarily make it so, in substance.

¹⁴ For a state government, a tax on the income of corporations with *nonresident* owners may be very attractive because it permits tax burdens to be shifted to nonresident individuals. This is not an application of the principle of taxation in accordance with ability to pay; rather, it represents the notion that a state can promote the interests of its residents by shifting or exporting tax burdens to nonresidents where possible. Using business taxes in this way again has nothing to do with imposing tax burdens on businesses proper, but rather on using business taxation as an administrative device to impose tax burdens on natural persons in a preferred manner.

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ceived. For example, taxes on trucks and other highway users are frequently cited as "benefit" taxes, but these taxes are seldom based on any direct measurement of benefits. Similarly, the courts have used the argument that businesses should be taxable in a state because they benefit from the "protection of the courts" there, for instance in litigation involving contract enforcement. But what is the proper amount that businesses should pay for such protection?

A more sophisticated interpretation of the benefit principle distinguishes between *total* and *marginal* benefit. If highways or courts did not exist at all, trucks would be worthless and businesses could hardly exist. The *total* benefit of highways to trucking firms might be the entire income of those firms, and the *total* benefit of the courts might be the entire income of all businesses and households. However, in the context of practical policymaking, the issue is not whether to have highways or courts at all, but rather whether to spend somewhat more or less on highways and courts, and if so, how to finance those incremental or *marginal* expenditures. According to the benefit principle, taxes should be assessed in accordance with the benefits of the marginal expenditures. This concept is familiar from ordinary exchange transactions in the marketplace. Food is essential to life, but the price of food reflects not its total value, but rather the value of the last or marginal unit of food. For this reason, the income accruing to the agricultural sector of the economy is closer to 5 percent of national income rather than 100 percent. The same logic should apply in invocations of the benefit principle of taxation.

Understanding the difference between marginal and total benefit does not solve the problem of benefit measurement. Economic methods such as benefit-cost analysis could be used to shed more light on this question, but in practice this is rarely done. As a practical tool, therefore, the benefit principle remains difficult to apply.

VERTICAL AND HORIZONTAL EQUITY

The concepts of vertical and horizontal equity are sometimes useful in analyzing tax policy. The principle of "horizontal equity" states that similarly-situated taxpayers should pay similar amounts of tax, that the tax system should not differentiate tax burdens "arbitrarily" among taxpayers. In practice, this principle is often applied in favor of more uniform treatment of taxpayers, for instance in arguing against tax preferences (special exemptions, depreciation rules, or other "loop-holes") for particular industries or types of income (capital gains, pension distributions, or in-kind compensation in the form of fringe benefits). Tax policies that promote horizontal equity, which is often briefly characterized as "equal treatment of equals," often also promote economic efficiency. As described earlier, efficiency is often enhanced by broad based and uniform tax policies. Special tax treatment for particular industries or for particular kinds of income creates fiscal incentives to change investment, employment, or other kinds of economic behavior at the same time that it treats similarly situated taxpayers unequally.

The principle of "vertical equity," sometimes summarized as "unequal treatment of unequals" is a natural companion of horizontal equity. It requires that differently-situated taxpayers should be taxed differently. In practice, this princi-

ple is used to justify heavier taxation for households with higher levels of income, property owners with greater amounts of property, or consumers with higher levels of consumption.

OTHER CRITERIA FOR TAX POLICY EVALUATION

Efficiency and equity are perhaps the two most fundamental desiderata for a tax system, but many other considerations are often promoted as important principles of taxation. Whether these are really different from equity and efficiency or simply aspects of these basic principles can be debated, but they certainly deserve mention.

ADMINISTRATIVE CONSIDERATIONS:

SIMPLICITY, ENFORCEABILITY, TRANSPARENCY

Taxpayers and tax administrators alike express dissatisfaction with the complexity of the tax system. There are real economic costs associated with tax *compliance*, one part of which is the time and money devoted to filling out tax forms, maintaining tax records, the hiring of tax advisers, and the public resources devoted to tax collection, including the processing of tax forms, verification of tax information including the cost of audits, and the costs to tax authorities and to taxpayers of the costs of litigation. There are also real economic costs associated with tax *planning*. Firms may be taxed very differently depending on their organizational form (proprietorship, limited-liability company, partnership, or one of several different forms of corporation). There may be tax advantages from organizing different parts of a business in different forms, or perhaps from locating different parts of a business in different localities, states, or countries. Households may experience significant tax consequences in buying and selling a home; holding assets in bank accounts, stocks, or bonds; using credit-card debt or home-equity loans; working as an employee or as an independent contractor; or in living in one state or locality and working in another, but understanding these tax consequences is often very difficult.

Aside from the efficiency costs resulting from the use of scarce resources in tax compliance and tax planning, a complex tax system can be unfair because not all taxpayers are equally adept at structuring their activities so as to avoid unfavorable tax outcomes. This might be seen as a form of horizontal inequity: tax burdens should not be differentiated among taxpayers because some are more adept at exploiting legal and administrative technicalities than others. For all of these reasons, it is important for tax policies to be simple, to be enforceable at reasonable cost, and to be as transparent as possible.

COMPETITIVENESS

The term "competitiveness" is often invoked, and perhaps misused, in discussions of tax policy. It appears to reflect a recognition that the tax policy of a state or local government affects the locational decisions of households and businesses.

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Kentucky, and localities within the state, must compete for capital, skilled labor, entrepreneurial talent, and other productive resources. Other things the same, heavy taxation of these resources will make Kentucky a less attractive location for them. If "competitiveness" means the creation of a more attractive fiscal environment for productive resources, it suggests that these resources should escape taxation, or, even more, that they should be subsidized. Competitiveness, in this sense, is not a principle of taxation that is justified by economic analysis. The fact that states and localities operate in competitive environments, however, does carry important implications for tax policy.

If the rate of return on investment, net of tax, is higher in Kentucky than elsewhere, capital will flow into the state. If the rate of return on investment is lower than elsewhere, capital will flow out of the state. The same is true for other productive resources, including both skilled and unskilled labor. From the viewpoint of economic efficiency, Kentucky's fiscal policies should impose taxes on productive resources that reflect the costs of the public goods and services provided to them when they locate in the state, but should otherwise neither increase nor decrease their net return. From the viewpoint of equity, the potential flow of resources into or out of a state or locality means that there are limits on the ability of a government to use tax (or expenditure) policies to make one group better off at the expense of another.

For example, highly-skilled workers (those with professional training such as physicians, scientists and technical personnel, skillful managers and entrepreneurs, and others with high earnings) are potentially employable in states other than Kentucky. If Kentucky's tax policy is highly unfavorable to these workers, and if the state does not offer offsetting fiscal advantages (for example, in the form of public services valued by these workers), then fewer of them will be attracted to Kentucky and some of those residing within the state will be attracted elsewhere. As this occurs, the services of those that remain will be increasingly scarce and costly, compensating them for the extra fiscal burden imposed upon them. The incomes of other residents in the state will suffer, even though they may benefit from reduced tax burdens. If skilled workers were relatively immobile, the imposition of heavy taxes on them would enable the state to reduce tax burdens on lower-skilled workers, but since Kentucky must compete for their skills, the state's ability to use its fiscal policies to lower the net incomes of highly skilled workers is limited.

The same logic applies to the taxation of the return to investment. Investors seek to obtain the highest rate of return on their capital. If a state attempts to impose heavy taxes on investment, the owners of capital will have an incentive to move capital to other states (or countries), unless of course the taxes are used to provide public services that compensate, or more than compensate, for the burden of the taxes themselves. (Thus, for example, if taxes on business income are used to meet urgent demands for transportation improvements, thus increasing the productivity of capital investment, heavier taxation of businesses might attract rather than repel investment.) The mobility of capital limits the state's ability to use fiscal policy to reduce the net rate of return on capital while raising the net incomes of others through more favorable tax treatment.

Thus, competition for productive resources limits the ability of a state or local government to pursue "vertical" equity objectives, if by this one means policies that aggressively redistribute income from one group to another. Such policies may be ineffective in achieving their goals, and in addition they impose efficiency costs. These considerations are most important in evaluating the fiscal treatment of highly mobile resources, and least important, or not important at all, in evaluating the tax treatment of immobile resources such as land or minerals.

ADEQUACY

The tax system must, of course, meet its fundamental objective of providing sufficient revenues for government expenditures. "Revenue adequacy," however, is not a static concept. The desired level of public expenditure varies over time, both in response to changing attitudes and preferences about the proper role of state and local governments and in response to changing economic conditions. Recessions, changes in the pattern of consumption, changes in the age structure or employment patterns of the population, and the growth and contraction of different industries not only make it difficult to forecast revenue with precision, but also demand frequent reconsideration of tax policy.

Furthermore, the desired level of public expenditure cannot be determined independently of tax considerations. As described above, the efficiency costs of taxation rise as taxes are exploited more heavily. When rates of taxation are low and the tax system is efficiently structured, the efficiency costs of taxation are modest. If higher levels of revenue are required, however, the efficiency costs of taxation also rise. From the perspective of benefit-cost analysis, these "indirect" efficiency costs of taxation need to be taken into account in deciding how much spending is to be financed.

While it is difficult to determine what amount of revenue is "adequate" in any one year or over a long planning horizon, the related concept of "revenue neutrality" is a helpful analytical tool. A "revenue neutral" tax reform is one that preserves existing or projected revenue flows, without prejudging whether this is or is not an appropriate policy goal in itself. Thinking about revenue-neutral tax reforms simply allows discussion to focus on the tax structure proper, separately from the question of whether public expenditures should be higher or lower.

TAXATION, EXPENDITURE, AND DEBT POLICY

In concluding this discussion of basic principles for the evaluation of tax policy, it is important to appreciate that the fundamental goals of equity and efficiency are not relevant to issues of taxation alone. They are equally important in the evaluation of the expenditure side of the government's accounts. Indeed, the separation of expenditure and tax policy, while sometimes helpful in organizing analysis and discussion, can be misleading. For example, government subsidies or transfer payments often give rise to efficiency effects very similar to those that result from taxation, and equity considerations are frequently of great relevance for these types of policies. Government debt policies also raise very similar issues; in fact, economists often regard debt policy as nothing more than the implementation of tax policy over time. In any one year, government expenditures must be financed

either from tax revenues or from borrowing. The decision to borrow means that interest and debt repayments will have to be made in future years, requiring additional taxation at that time. Thus, the decision to borrow is in effect a decision to impose lighter taxation now in exchange for higher taxes in the future. The same efficiency and equity criteria that are used to evaluate taxation at a point in time can be applied to the evaluation of taxation at different points in time.

DIFFICULT TRADEOFFS

We have now reviewed numerous criteria—many of the most important, but not an exhaustive list—by which tax policies can be evaluated. Each of these criteria has some appeal, at least to most observers. Unfortunately, these criteria frequently come into conflict, and sensible policy choice usually requires that they be balanced against one another.

One classic illustration arises in the analysis of tax progressivity. To many people, the ability to pay and vertical equity criteria mean that taxes should be assessed more heavily on higher-income households. As a corollary of this view, many people would also favor the use of tax revenues to provide public services or cash transfers to poor households, for example in the form of welfare benefits, health benefits, or other forms of means-tested public assistance. Kentucky, or a locality within Kentucky, might attempt to promote these policy goals by instituting a highly progressive income tax, with high rates of taxation, so as to finance generous social services for the poor. Even if we accept the notion that this policy would be attractive on equity grounds, it would give rise to at least two important types of efficiency losses. First, it would create fiscal disincentives for households to earn high levels of income, and it would thereby discourage work effort and the accumulation of wealth (or more precisely, the accumulation of wealth in non-tax-sheltered forms). On the expenditure side, the policy would discourage work effort and savings on the part of poor households, since, with means-tested programs, their work efforts result in benefit reductions, thus creating a fiscal incentive to devote less time and effort to the earning of income. Second, such a policy would create incentives for high-income households to reside in other states or localities, while making the state or locality a more attractive location for poor households.

Neither of these types of behavioral responses would necessarily occur instantly; in general, the incentive effects of fiscal policies become more pronounced over time. Nevertheless, a large body of economic research confirms the common-sense observation that people do respond to the economic incentives embodied in tax and expenditure policies, both with respect to the effort that they expend to achieve higher incomes and with respect to locational choices. The locational dimension is especially important for relatively small jurisdictions, such as cities or counties, since it is comparatively less costly for people to move over short distances. States can also experience significant movement of people across

their borders as well, however.¹⁵ The pursuit of equity goals in tax policy can thus come into conflict with efficiency goals. This type of conflict is the rule rather than the exception, and the challenge for public policy is to strike a satisfactory balance. There is usually no simple and unambiguously preferred solution to the vexing problem of taxation.

¹⁵ Of the approximately 270 million U.S. residents in 1999-2000, approximately 43 million changed locations in that year. Almost all of these relocations occurred within the United States; less than 2 million involved international migration. Of the nearly 42 million moves that occurred from one place to another in the United States, well over half involved moves from one location to another within the same county; about 8 million involved moves to another county in the same state, and about 8 million were interstate moves. (These are only the most recent statistics. Census data confirm that the phenomenon of frequent relocation has been a persistent feature of U.S. demographics for the past half-century.) No state is exempt from this pattern, though of course the extent of movement varies among the states and regions. Interestingly enough, as of the 1990 census, Kentucky stands out among the states as one that has experienced relatively little inflow from the rest of the country. In this year, 77 percent of the state's residents were native Kentuckians, ranking fourth highest among the states in this respect. By way of comparison, only 62 percent of the 1990 U.S. population were residents in their state of birth. Pennsylvania ranked first in this dimension, with 80 percent native residents, and Florida was last, with only 30 percent natives. Unfortunately, the data from the 2000 census are not yet available. The 1990 data indicate that Kentucky had not attracted many new residents from other states or from abroad during the preceding several decades.

2

RECENT TRENDS IN KENTUCKY STATE AND LOCAL TAX POLICY

By David E. Wildasin

A review of trends in tax policy in Kentucky, and a comparison of taxation in Kentucky with other states and localities elsewhere in the nation, provides a foundation for discussion of possible reforms. Taking state and local governments together, tax burdens in Kentucky, expressed as a share of income, have risen gradually over time, bringing Kentucky closer to the U.S. average. By contrast with the rest of the country, Kentucky relies more heavily on the state government to collect taxes and less heavily on localities. Income taxes play a more prominent role in the tax structure of both state and (especially) local governments in Kentucky than elsewhere in the country, while local property taxes are comparatively less important. Substantial fiscal transfers from the state to the local governments, primarily for the financing of local schools, are a noteworthy feature of Kentucky's fiscal system.

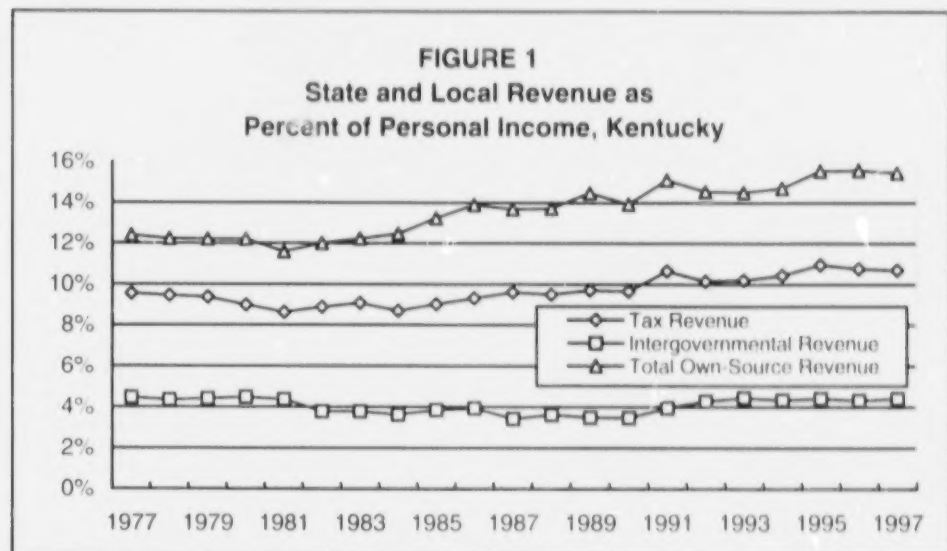
As difficult as it may be to find an ideal system of taxation, revenues do have to be raised somehow. Tax policies change over time because of changing economic conditions, as a matter of deliberate policy choice, and in response to changing legal and other constraints on policy. This chapter reviews, in a summary fashion, some of the principal developments in the evolution of Kentucky's fiscal system over recent years.

Perhaps it is best to begin with an overview of the trends in the levels of different revenue sources, first for state and local governments combined and then for each separately. Subsequent discussion then examines the composition of revenues and direct attention toward particular components of the overall fiscal system.



TRENDS IN REVENUES FOR STATE AND LOCAL GOVERNMENT

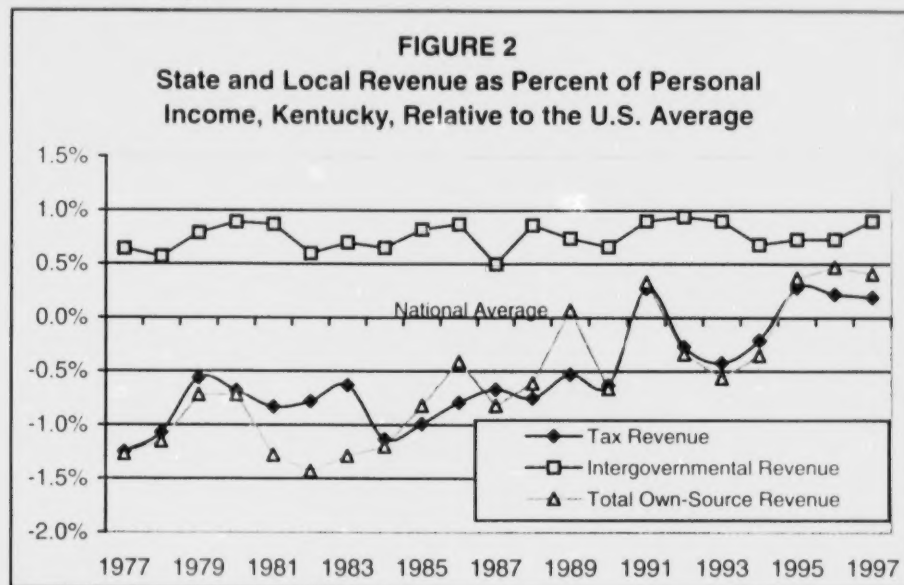
The overall level of taxation in Kentucky can be measured in many different ways, and no one way of doing so is uniquely correct. Over time, the total amount of tax revenue has certainly risen, but of course the population and economy of the state vary over time as well. One useful way to describe the broad trend in the amount of revenue is to express tax revenues as a proportion of total income. Figure 1 shows that total own-source revenues have increased gradually as a share of personal income in Kentucky over the past quarter century, presently constituting about 15 percent of income.¹⁶ These own-source revenues include both tax and nontax revenues such as charges of various kinds (from higher-education institutions, hospitals, and the like) plus miscellaneous revenues like interest earnings. As shown in Figure 1, these nontax revenue sources are quite significant in magnitude, although tax revenues of course account for the largest share of own-source revenues. Kentucky, like other states, also receives a significant amount of revenue in the form of transfers from the federal government; as shown in the figure, these have consistently amounted to about 5 percent of personal income.



It is natural to ask how Kentucky's fiscal system compares with those in the rest of the country. Figure 2 sheds some light on this question by showing the result of a comparison of the data in Figure 1 with comparable data calculated for all state and local governments in the United States. This figure, like several to follow, looks at the difference between fiscal indicators for Kentucky and those for state and local governments for the country as a whole. Where this difference is equal to zero, the value of the fiscal variable for Kentucky is identical to the value for the same variable for all state and local governments in the United States, al-

¹⁶ The discussion in this chapter is drawn from data available from the U.S. Census Bureau, especially the *Census of Governments*.

ways expressing these variables as a proportion of personal income. Thus, as Figure 2 shows, Kentucky has consistently received intergovernmental transfers that are somewhat higher, as a share of personal income, than is true for other U.S. state and local governments. One can also see from Figure 2 that state and local governments in Kentucky collected a somewhat smaller fraction of income in taxes, relative to other state and local governments, until roughly the early 1990s; since that time, Kentucky's performance in this regard has been relatively close to the national average.



Figures 3-6 break this fiscal picture down by level of government. Figure 3 shows the amount of state government revenue, again separating out own-source from intergovernmental revenue, and distinguishing tax revenue from nontax sources, showing in particular that state tax revenue has risen gradually though not dramatically over time, expressed as a share of personal income. Note from Figure 4 that state government revenues in Kentucky have been consistently higher, as a share of income, than for other state governments in the United States. Most of this difference is attributable to a higher share of own-source revenues.

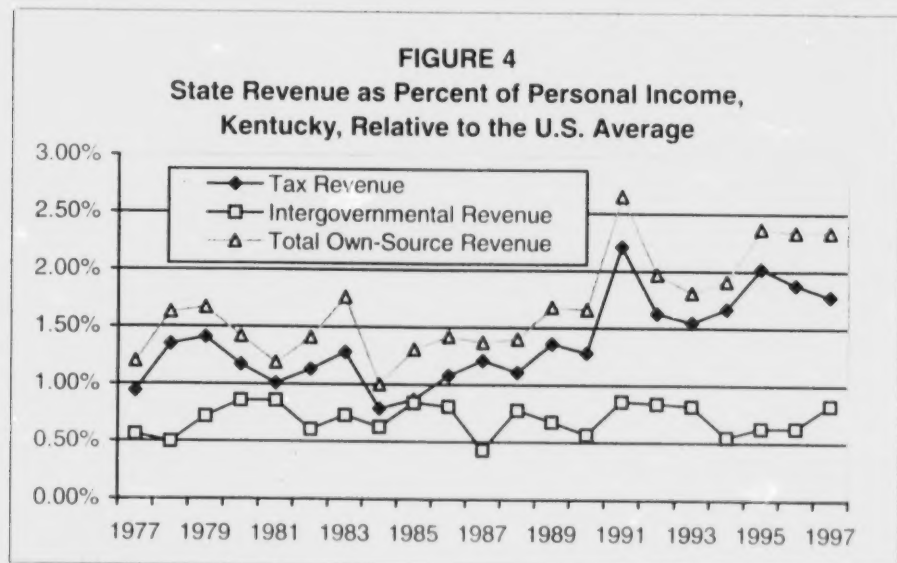
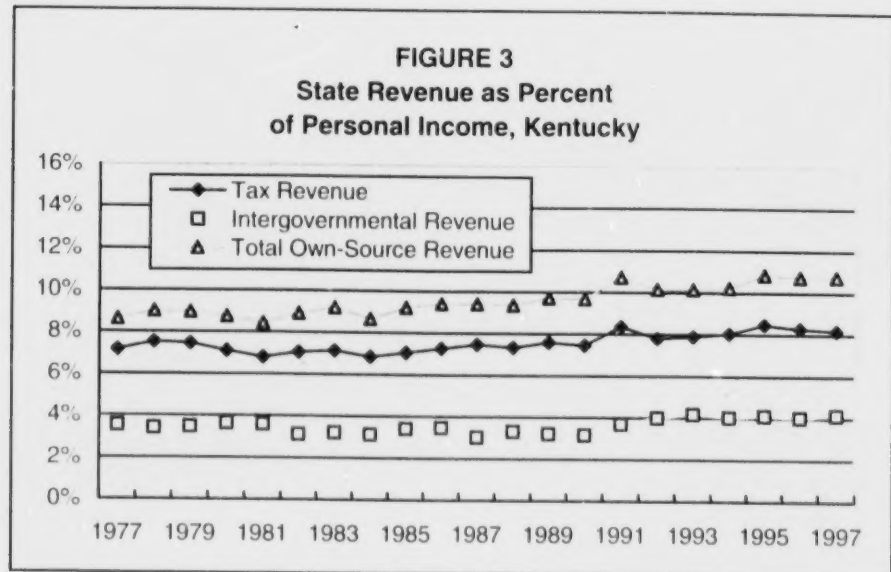
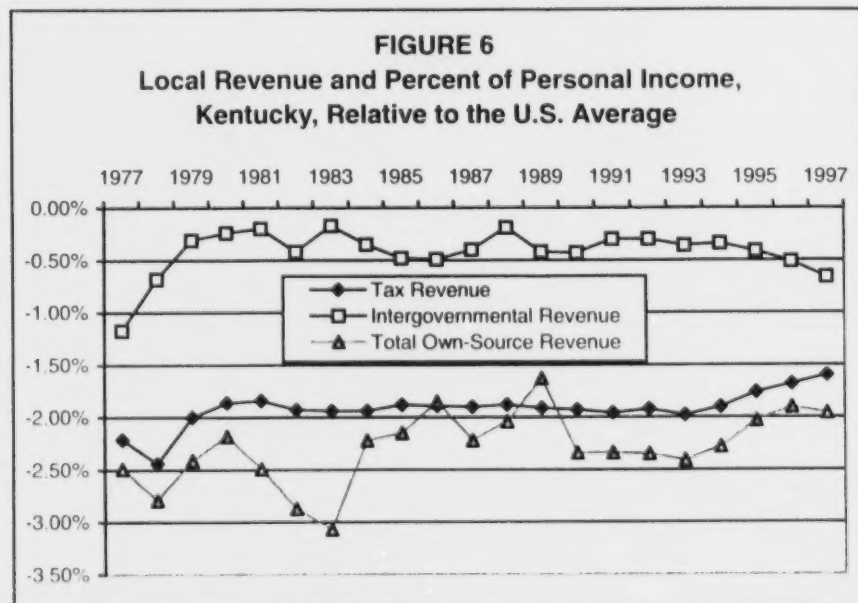
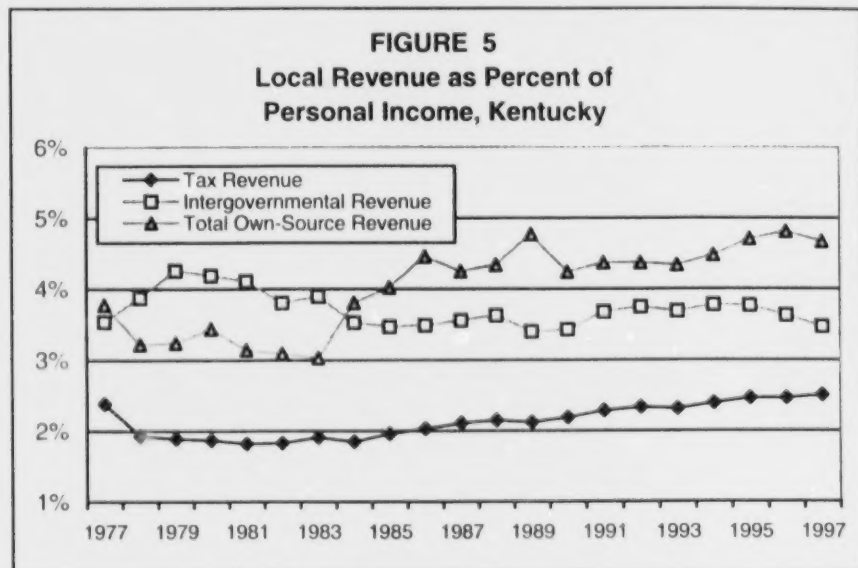


Figure 5 shows the trend of local government revenues over time. Note first that intergovernmental transfers now include transfers from the state government as well as from the federal government. State-local transfers are a major source of revenue for local governments in Kentucky, consistently exceeding local tax revenues and sometimes exceeding total own-source revenues for local governments. Note also that nontax revenues are much more important for local governments than for the state, often accounting for close to half of local own-source revenues. Figure 6 shows that local governments in Kentucky are not unique in their dependence on transfers from higher-level governments, and in fact receive transfers, as a share of income, that are actually slightly less than average for the nation

as a whole. More remarkable is the relatively low level of own-source revenues for local governments in Kentucky, including both tax and nontax revenues.



Putting together the results of Figures 1 through 6, one can see that the overall revenue picture for state and local governments in Kentucky, when combined, is not too different from that for other state and local governments in the United States. However, the balance between state and local revenues in Kentucky is quite different from that for the rest of the country, with state government revenues accounting for a relatively high share of personal income and with local government own-source revenues a relatively low share.

MAJOR ELEMENTS OF STATE AND LOCAL TAX STRUCTURE

Let us now focus more specifically on the major taxes used by state and local governments in Kentucky. The chief revenue sources for state and local governments in Kentucky are and have traditionally been taxes on income, on sales, and on property. However, the degree of reliance on each of these sources fluctuates over time, at the state and local levels individually and for state and local governments combined, and Kentucky differs from other states in some important ways.

To begin with, Table 1 shows that the "big three" revenue sources account for about 90 percent of all revenues for state and local governments, both in Kentucky and for the nation as a whole. As Table 1 shows, Kentucky is much like other states in this respect. It is noteworthy, however, that the combined state and local government fiscal system in Kentucky exhibits much greater reliance on income taxes and much less reliance on property taxes than other state and local governments in the United States. As is clear from the bottom panel of the Table, which reports the revenue sources for state governments alone, the relatively limited reliance on property taxes and relatively heavy dependence on income taxes is not attributable to the state-level revenue structure; in fact, at the state level, Kentucky depends somewhat less heavily on income taxes, and somewhat more heavily on property taxes, than other states throughout the country. This indicates that many of the important differences between Kentucky's revenue system and that of other states arise from the system of *local* government finance, as is discussed further.

TABLE 1
Composition of Revenue, State and Local Governments,
Kentucky and US, 1997

State and Local Governments Combined				
	Percent of Total			
	Income Taxes*	Sales Taxes	Property Taxes	Sum
Kentucky	34.5	37.7	17.2	89.4
US	26.5	35.9	30.0	92.4
State Government Only				
Kentucky	36.7	48.7	6.1	90.6
US	39.6	46.8	2.3	89.5

* Includes local occupational tax and state corporate income tax.

Figures 7 and 8 illustrate the development, over time, of the combined tax structures of the state and local governments in Kentucky. Figure 7 shows that most of the major taxes have been fairly stable as a share of personal income over the past 25 years, although income taxes have exhibited significant growth, especially during the past decade. Figure 8 shows that property taxes have persistently made a relatively modest contribution to state and local tax revenue in Kentucky, by comparison with other states. By contrast, Kentucky has depended more heavily on income taxes as compared with other states, particularly in recent years.

FIGURE 7
State and Local Tax Revenue as
Percent of Personal Income, Kentucky

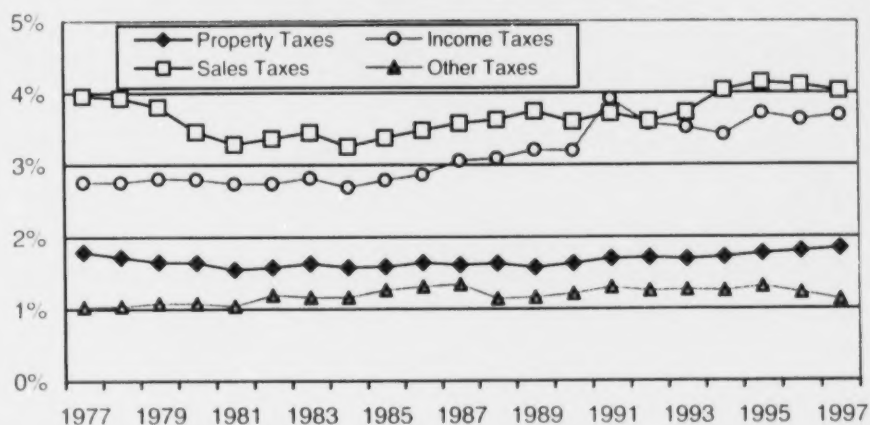
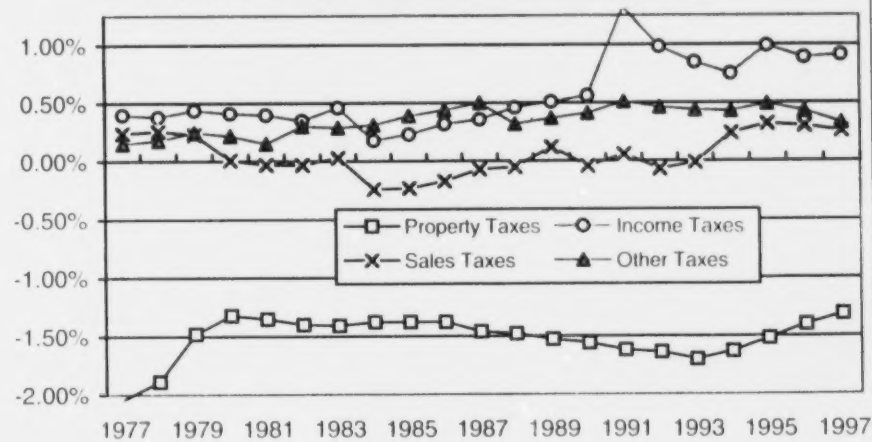


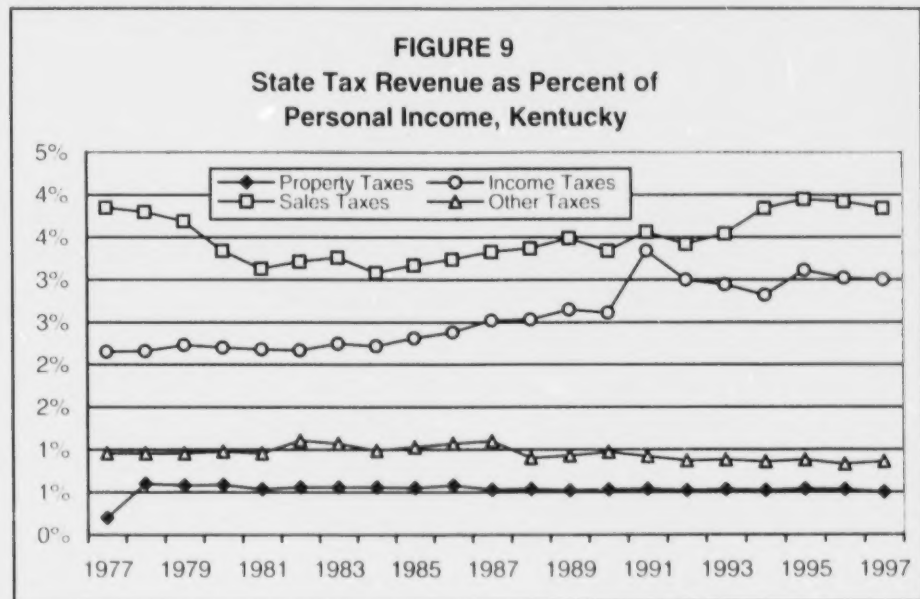
FIGURE 8
State and Local Tax Revenue as Percent of Personal
Income, Kentucky, Relative to the U.S. Average

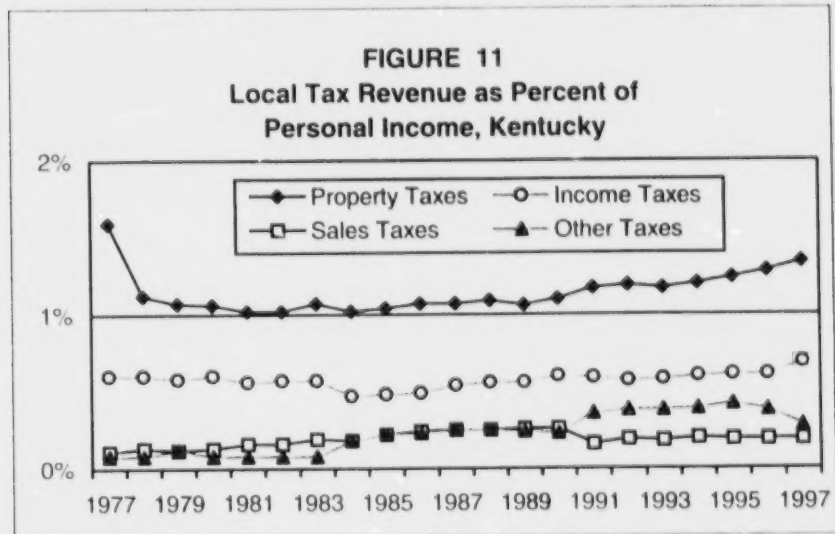
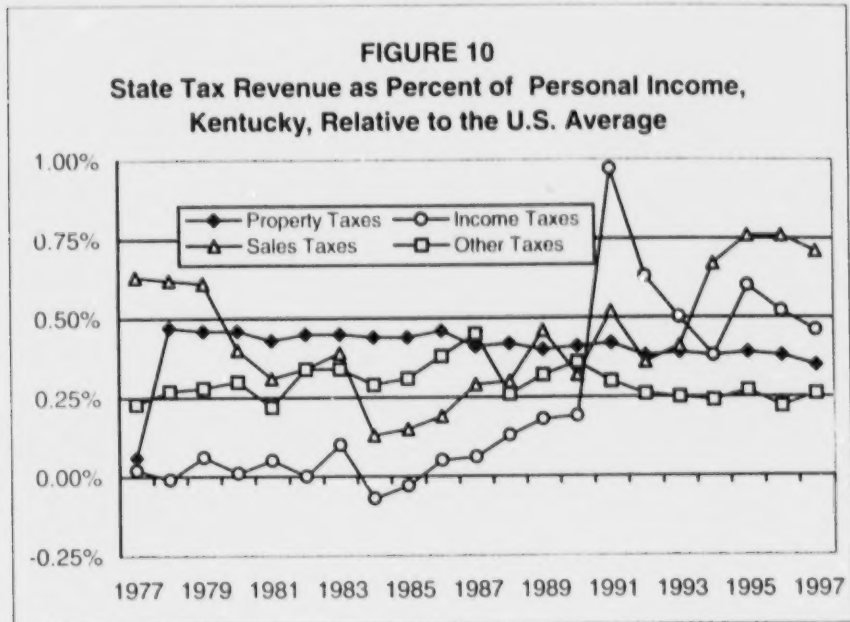


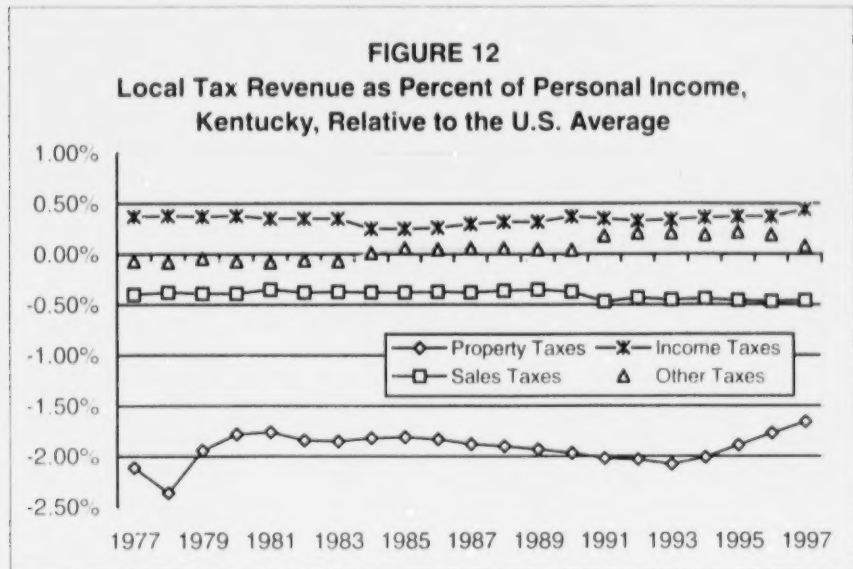
Once again, it is important to decompose the combined state and local sector in order to look at each level of government separately. Figure 9 shows that the income and sales taxes are the most substantial contributors to the state's tax system, with both having risen somewhat in recent years. Figure 10 reveals that state-level taxes in general—not just the income and sales taxes, but the state property tax and other taxes as well—are relatively high in Kentucky. This is not unexpected, in view of Figure 4. As for local governments, Figure 11 shows that the property tax has been a major contributor to local tax revenues, with other local

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taxes playing a somewhat more limited role. These other taxes, however, are much more important in Kentucky than elsewhere in the United States, as shown in Figure 12. Most remarkably, Figure 12 shows that local governments in Kentucky are far less dependent on property taxes than is the case for local governments elsewhere in the United States, although this differential has diminished somewhat over time.







A CLOSER LOOK AT EDUCATION FINANCE

In describing state and local government finance in Kentucky, it is important to pay particular attention to education finance. In Kentucky, as elsewhere in the country, both state government and local governments—the local school districts—share responsibility for education finance and expenditures. This and other important features of school finance in Kentucky are illustrated in Tables 2 and 3. To begin with, the first four columns of Table 2 show that total state and local expenditures on education in Kentucky, expressed as a share of personal income and as a share of total state and local expenditures, have been relatively stable over time and have not differed dramatically from comparable figures for other states. Of all state and local expenditures, Kentucky's school districts have consistently accounted for a bit more than 60 percent, and in this respect as well, Kentucky's experience has been similar to that for other states.

TABLE 2
**State and Local Education Expenditures,
KY and US, Selected Years**

Year	As Percent of Income		As Percent of Expenditures		School District Share	
	KY	US	KY	US	KY	US
1972	6.32	6.66	34.6	34.6	62.2	57.9
1977	6.24	6.30	33.7	31.7	60.7	59.0
1982	5.39	5.60	29.5	29.4	61.0	59.3
1987	5.69	5.74	29.2	29.2	61.6	59.7
1992	6.17	6.04	28.1	28.1	61.3	60.0
1997	6.44	6.04	28.7	28.7	63.7	60.4

When we look more closely at the relative roles of state and local governments in education spending, however, we see some significant differences between Kentucky and national averages. Table 3 shows the relative importance of different revenue sources for local school districts, both for Kentucky and for school districts elsewhere in the nation. The first two columns show that intergovernmental revenue, that is, transfers from higher-level governments, have accounted for 60 to 75 percent of school district revenues in Kentucky during the past quarter century, significantly higher than the corresponding national average of 45 to 55 percent.¹⁷ School districts in Kentucky are thus substantially more dependent on state government transfers than is true elsewhere in the country. Not surprisingly, taxes collected by local school districts account for a much smaller share of school-district revenue in Kentucky as compared with other states. Furthermore, while the local property tax accounts for a substantial share of local school district tax revenue in Kentucky (for example, about 72 percent in 1997), other local taxes are far more important to Kentucky school districts as compared with other states. In the rest of the country, over 95 percent of local school district tax revenues have consistently been obtained from local property taxes.

TABLE 3
Sources of Revenue for School Districts, KY and US,
Selected Years

Year	Intergovernmental Revenue		Own-Source Revenue			
			Tax Revenue		Property Tax Share	
	KY	US	KY	US	KY	US
1972	61.0	44.8	29.7	48.0	87.2	98.1
1977	61.0	50.1	29.8	43.1	84.5	97.5
1982	74.4	54.1	18.7	36.9	70.4	96.8
1987	72.3	54.9	21.2	37.2	64.9	97.5
1992	73.2	53.8	23.6	38.3	67.4	97.4
1997	67.8	55.2	26.7	37.2	72.2	96.9

Note: "Property Tax Share" is property tax revenue as a share of all school district tax revenue.

SUMMARY

In this overview of Kentucky's fiscal system, a few important points stand out. First, the combined state/local tax burden in Kentucky is not dramatically different from that found elsewhere in the United States, at least when measured in relation to personal income. Kentucky does differ from other states in the *composition* of its tax structure. Income taxes play a larger role in Kentucky than is true elsewhere in the country, both at the state and the local level. By contrast, while the local property tax remains a major revenue source for local governments in Kentucky, this is much less the case than for other local governments in the

¹⁷ Both in Kentucky and elsewhere in the country, almost all of these transfers come from the state government, with transfers from the federal government accounting for less than 5 percent of all intergovernmental revenue received by school districts.

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United States. With respect to primary and secondary education, Kentucky's overall expenditures do not differ markedly from other states. But the financing of education spending is quite different, with Kentucky relying much more heavily on the state government to finance local school districts. These features of Kentucky's fiscal system are interrelated. Since the property tax plays a minor role as a revenue source for the state government but a major role for local governments, heavy state involvement in education finance is likely to contribute to a shift in the combined state-local fiscal system away from property taxation and toward income and sales taxation.

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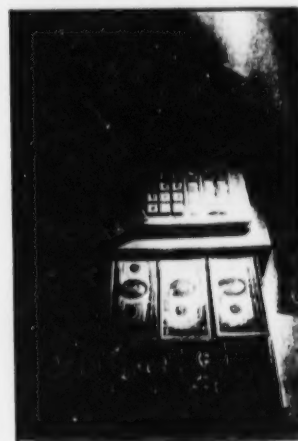
SALES TAXATION IN KENTUCKY

Problems and Prospects

By David E. Wildasin

The sales and use tax is one of the major revenue sources for Kentucky, as it is for many states. This tax is imposed on tangible goods but not on intangibles such as services. In this important respect, the tax is far from a comprehensive tax on household consumption. Furthermore, it appears that a substantial portion of sales tax revenue derives from the taxation of transactions between firms. This compounds the tax burden on some categories of goods, as they are taxed at multiple stages in the production process. This system creates high cumulative effective tax rates on some goods and very low tax rates on others. Reforms that would avoid multiple taxation of some goods while including currently untaxed categories of consumption would likely improve the efficiency of the tax system and bring the sales tax closer to a uniform tax on all consumption.

The discussion in Chapter 2 has identified some of the key elements of Kentucky's fiscal system. Every one of these features of the fiscal system, considered individually and in relation to each other, warrants close attention from the perspective of the principles outlined in Chapter 1. For example, first considering some components of the tax system in isolation, one should ask whether the personal income tax is equitable in its treatment of individual households. What are its efficiency implications for work effort or for savings and investment in Kentucky? Can compliance with and enforcement of this tax be made easier and less costly? Similarly, one can ask whether Kentucky's corporation income tax improves or detracts from efficiency in resource allocation. Is the corporation income tax too complex, and could it be simplified without sacrificing important policy objectives? Are corporate and noncorporate enterprises treated in uniform or disparate manners, and what are the efficiency and equity implications of doing so? Each of these questions is complex, important, and worthy of serious analysis. The same is true for similar



issues that could be raised with respect to the state and local property taxes, local occupational license taxes, school district finance, and other elements of the state's fiscal system. Equally importantly, one should consider how the elements of this system work together. Has Kentucky achieved the right balance between individual and business taxes? Should the state shift its emphasis away from sales taxation and toward income taxation, or perhaps the opposite? Should local governments play a larger role in raising revenues to finance their policies and programs, or would it be better for the state to assist them with higher levels of transfers?

It is impossible to address all of these issues adequately within the scope of this study. This chapter is devoted to the analysis of just one component of the state's overall tax system, the general sales tax, and in fact it focuses on just a few features, hitherto relatively neglected, of this tax. A review of the sales tax and a discussion of possible sales tax reforms illustrates the application of some of the basic tax principles discussed in Chapter 1, and of the ways in which these principles can come into conflict, requiring careful balance among them.

KENTUCKY'S SALES TAX: SOME KEY FEATURES

As we have seen, the sales and use tax is one of the major revenue sources for Kentucky, as it is for many states. In its present form, Kentucky's sales tax is generally imposed on retail sales of tangible products, where "retail" means that the taxed commodity is not to be resold. When tangible products are purchased from out-of-state vendors, use tax is to be paid unless the products are resold. There are many specific exemptions from the sales and use taxes, however. When otherwise taxable products are purchased by governmental and nonprofit entities, they are typically exempt from tax. Furthermore, many products purchased for agricultural use are exempt, as are such items as coal used for electricity production, fuels used in energy-intensive industries, motor vehicles, etc. At the household level, perhaps the most important exemption is that for food. In some cases (motor vehicles, coal, and fuels, for example), products that are exempt from sales and use tax are subject to other taxes. Several important issues arise concerning sales and use taxes in Kentucky.

First, because the tax is levied only on *tangible* products, it exempts services from taxation. The service sector is a large and growing share of the state's economy, a trend that may accelerate due to the growth of electronic commerce, but that, in any case, has been quite pronounced for some time. Exclusive reliance on sales taxation of tangible goods may therefore limit revenue growth over time, especially in relation to the size of the state's economy. Moreover, the exemption of services from sales and use tax gives rise to differential tax burdens across sectors, creating fiscal incentives for the economically inefficient expansion of the service sector at the expense of manufacturing and other activities that produce tangible goods.

Second, the administration and enforcement of use taxes is difficult and, at least at the level of households, not very successful. In the absence of effective enforcement of use taxes, in-state vendors are fiscally-disadvantaged relative to out-of-state vendors, and household consumption patterns are distorted in favor of goods that are purchased from outside of the state and away from goods that are locally produced. For both reasons, the difficulties in use tax collection and enforcement cause economic inefficiency: consumption and production decisions are driven, in part, by tax considerations rather than by underlying economic benefits and costs. To the extent that electronic commerce creates greater opportunities for households (and, to a lesser extent, businesses) to purchase goods from out-of-state vendors, this problem is of growing importance. If the sales and use tax base were expanded to include intangible products, use tax enforcement would become an issue of still greater significance, since it can be especially difficult to monitor and tax the electronic delivery of services.

Third, sales and use taxes are imposed not only on *final consumption*, that is, sales to households, but also on *intermediate* products, that is, sales to businesses, except when the products are themselves resold. The sales and use tax is therefore something of a hybrid, containing elements of a tax on final consumption together with elements of a turnover tax, that is, a tax on all sales. Turnover taxes, and other taxes on intermediate-goods transactions, are generally harmful to efficient resource allocation in a number of respects. Taxes on intermediate goods encourage firms to use other, untaxed inputs in the production process, thus distorting the efficiency of production. They encourage firms to perform tasks internally rather than to purchase from other firms, since internal transactions are not subject to tax; this gives rise to incentives that lead to increased vertical integration of firms (whether through internal expansion or through mergers and acquisitions) and creates fiscal penalties for small businesses. Taxes on intermediate goods also increase the effective rates of taxation on final consumption because taxes incurred in prior (upstream) stages of the production process are costs of production that must be recovered through higher product prices. The cumulative effective tax on a given category of final consumption can be substantially greater than the statutory rates at the point of final sale because of the cascading of taxes on intermediate stages of production. Moreover, these cumulative effective tax rates will vary across consumption categories, depending on the extent to which taxable intermediate goods are utilized in the upstream production process and on the degree of vertical integration in the production process.

The *incidence* of the sales tax is also a potential matter of concern. It is sometimes argued that the sales tax is regressive in its incidence because low-income households consume a larger fraction of their incomes than high-income households. The exemptions for food, health-care related items, and other "necessities" are often justified on the ground that they shift the sales tax burden away from low-income toward middle- and higher-income households. Since the tax is imposed at a flat rate on goods rather than on households, it is not possible to differentiate sales tax liabilities in a way that reflects the varying circumstances of individual households, such as income levels, family size, health status, or age. On the other hand, Kentucky already relies heavily on income taxes, and higher tax

burdens on better-off households could undermine the state's ability to compete for skilled workers, entrepreneurial talent, and complementary resources such as business investment, research and development, and the like. This is especially so if taxes imposed on higher-income households are used to finance services that benefit primarily low-income Kentuckians.

Another important equity concern arises from the uneven application of the sales tax across categories of consumption. Since intangibles are not taxed, households that consume such services and those who have invested or who are employed in service-related industries are taxed more lightly than other citizens. Few would wish to argue that these differences among households constitute a sound basis on which to differentiate tax burdens.

THE RETAIL SALES TAX AS A TAX ON INTERMEDIATE GOODS

As noted above, it is customary to view the sales tax as a tax on final consumption. However, as the tax is actually administered, in Kentucky and elsewhere, this is only partially accurate. A significant portion of the transactions that are subject to sales tax involve sales from one business to another, that is, "intermediate goods" transactions, rather than sales to consumers. Unfortunately, it is very difficult to determine with any accuracy the share of sales and use taxes that fall on intermediate goods in Kentucky. Businesses that collect sales taxes are not required to record whether taxable sales are made to final consumers or to businesses, and it is therefore not possible to measure directly whether sales taxes are collected on transactions involving households or businesses. One can estimate the amount of taxes collected on final consumption by measuring household expenditures and applying the statutory tax rate to those categories of expenditures that are subject to tax; by this procedure, it has been estimated¹⁸ that only about half (52 percent) of sales tax revenues in Kentucky derive from taxation of final consumption. This means that about half of the revenues are obtained from sales to businesses, i.e., from taxation of intermediate goods. By this estimate, then, it is quite misleading to view the sales tax as just a tax on final consumption; about half of the tax is collected in "upstream" transactions as goods pass through the production process en route to sales to consumers. This has important implications for understanding the sales tax in Kentucky in its present form, and for possible reforms of the sales tax.

The problem of cascading of taxes through the production process is easily illustrated with a hypothetical example. Since services are exempt from taxation, suppose that no firms that supply services purchase any taxable tangible products, that the upstream suppliers of these tangible products also do not purchase any taxable products, and that the same is true for all other firms in the upstream supply chain. Suppose also that firms that sell taxable tangible products to consumers also purchase taxable tangible inputs from their upstream suppliers, and that the

¹⁸ R. Ring, "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal* (March 1999). See also similar estimates by Michael Childress in Chapter 7 of this volume.

degree of taxation of intermediate goods in upstream production processes is the same for all producers of taxable final consumption goods. Under these assumptions, the state's economy is effectively divided into a portion that is completely exempt from tax (service providers and their upstream suppliers), and another portion that is taxable (firms supplying taxable tangible goods to consumers, and the upstream suppliers of these firms). If just half of sales tax revenue derives from a 6 percent tax on final consumption, then the prices of these taxable final consumption goods must also reflect an additional 6 percent of taxes collected at prior stages in the production process. This means that the cumulative effective rate of taxation on these goods must be 12 percent. That is, while tangible goods are taxed at a nominal rate of 6 percent, they are in effect taxed repeatedly in different stages of the production process, with the effective tax cumulating at each stage.

This simple example relies on unrealistic assumptions. In reality, the state's economy cannot be divided neatly into one part that entirely escapes sales taxation and one part that is uniformly taxed. Even if services escape taxation at the point of sale, service providers sometimes purchase taxed tangible products, or purchase goods and services from firms that themselves purchase taxed tangible products. Some indirect sales tax burden thus falls on firms producing untaxable services or exempt tangible goods. Firms that sell taxable tangible goods do not rely equally on the purchase of taxable inputs, and the extent of taxable transactions in the upstream stages of the production process varies from industry to industry. Thus, it would be more accurate to characterize the sales tax as a tax that produces a haphazard distribution of effective rates of taxation on different commodity categories.

It is not an easy matter to move beyond hypothetical calculations to estimate the actual distribution of tax rates across commodities because of the complexity of the sales tax system itself, with many specific exemptions for particular industries, because of the varying degrees to which different industries purchase inputs from and sell outputs to out-of-state firms and consumers, and because of our uncertain knowledge of industrial structure within the state. For example, there is a 9 percent tax on motor fuels, and automobiles are subject to a 6 percent tax at the time of registration, including registrations incident to title transfers of used vehicles, but neither are subject to the sales tax, proper. One might regard these special taxes as completely separate from the sales tax or they might be viewed as part of a combined tax structure with special features for particular industries. Other examples of specific exemptions are described further below.

The present analysis does not attempt to capture all of these complexities. Rather, for the sake of illustrative calculations, let us assume that industries producing "tangible goods," including motor vehicles, motor fuels, etc., are generally subject to taxation at a 6 percent rate, and that other industries (services, such as education, health care services, etc.) are exempt from this 6 percent tax. A state input-output table with 52 industries is used to describe the pattern of trade among

industries.¹⁹ In addition, in order to take partial account of particular exemptions for particular industries, or for particular uses of the output of some industries, let us allow for total or partial exemptions for the sales of some tangible goods. Table 4 lists the 50 industries (excluding the government sector) that appear in the state input-output table, and, in the second and third columns, the assumed statutory rate of taxation on the sales of each industry's output.²⁰

The last column of Table 4 presents estimates of the effective cumulative tax rate that would be borne by consumers of the output of the industries in each row. For example, in the case of lumber, the effective tax rate is 11 percent, reflecting the 6 percent paid directly by consumers at the point of purchase, but also another 5 percent resulting from sales taxes imposed in various "upstream" transactions in the production of lumber. One can see from this table that the cumulative rates are virtually zero for commodities that are not directly taxed when sold either to consumers or to businesses, although even in these cases there may be a very modest tax embedded in the final purchase price because these industries directly or indirectly utilize taxable commodities as inputs in their production process. By contrast, effective tax rates in the 9 to 12 percent ranges can be found for a number of other commodities. The weighted average tax rate for all commodities is approximately 5 percent, so we can see that some forms of consumption are taxed at effective rates approximately twice as great as average, while the effective rates are nearly zero for others.²¹

TABLE 4
Effective Sales Tax Rates, by Industry

Industry	Assumed Statutory Tax Rate		Effective Cumulative Tax Rate
	Households	Business	
Lumber	0.06	0.06	0.11
Furniture	0.06	0.06	0.09
Stone, Clay, etc.	0.06	0.03	0.08
Primary Metals	0.06	0.03	0.09
Fabricated Metals	0.06	0.03	0.09
Machinery and Computers	0.06	0.03	0.09
Electrical Equipment	0.06	0.03	0.08
Motor Vehicles	0.06	0.06	0.12
Rest of Trans Equipment	0.06	0.03	0.09
Instruments	0.06	0.03	0.08
Misc. Manufacturing	0.06	0.03	0.09

¹⁹ The Governor's Office of Economic Analysis has kindly provided an input-output table for Kentucky that it uses for studies of the economic impact of different policies. State and local input-output tables are notoriously difficult to construct owing to the lack of collection of primary data, and estimates based on them must be interpreted with care.

²⁰ Data on the share of each industry's output that is subject to sales tax are not collected, so there is no way to determine precisely what figures should appear in the second and third columns of Table 4. Richard Dobson, of the state Revenue Cabinet, kindly provided advice in making the rough estimates reported in this table.

²¹ This weighted average calculation weights each industry category by the amount of the good or service that is used by consumers.

TABLE 4 (Continued)
Effective Sales Tax Rates, by Industry

Industry	Assumed Statutory Tax Rate		Effective Cumulative Tax Rate
	Households	Business	
Food	0.00	0.00	0.01
Tobacco Manufacturing	0.06	0.06	0.08
Textiles	0.06	0.06	0.09
Apparel	0.06	0.06	0.10
Paper	0.06	0.03	0.09
Printing	0.06	0.03	0.08
Chemicals	0.06	0.03	0.09
Petroleum Products	0.06	0.03	0.08
Rubber	0.06	0.03	0.09
Leather	0.06	0.03	0.08
Mining	0.00	0.00	0.01
Construction	0.00	0.00	0.02
Railroad	0.00	0.00	0.01
Trucking	0.00	0.00	0.01
Local and Interurban Transportation	0.00	0.00	0.01
Air Transportation	0.00	0.00	0.01
Other Transportation	0.00	0.00	0.01
Communication	0.06	0.06	0.08
Public Utilities	0.00	0.03	0.01
Banking	0.00	0.00	0.01
Insurance	0.00	0.00	0.01
Credit & Finance	0.00	0.00	0.01
Real Estate	0.00	0.00	0.00
Eating & Drinking	0.06	0.06	0.07
Rest of Retail Trade	0.06	0.06	0.07
Wholesale Trade	0.00	0.00	0.01
Hotels	0.06	0.06	0.07
Personal Services & Repair	0.00	0.00	0.01
Private Household	0.00	0.00	0.00
Auto Repair & Service	0.06	0.06	0.08
Misc. Business Services	0.00	0.00	0.01
Amusement and Recreation	0.03	0.03	0.04
Motion Pictures	0.06	0.06	0.08
Medical	0.00	0.00	0.01
Misc. Professional Services	0.00	0.00	0.01
Education	0.00	0.00	0.01
Nonprofit Organizations	0.00	0.00	0.01
Ag., Forestry, Fishery Services	0.00	0.00	0.01
Farm	0.00	0.00	0.01

The effective sales tax rates shown in Table 4 should not be viewed as reliable estimates for all of the goods and services produced within Kentucky. What they do illustrate is that an apparently simple policy with 6 percent taxation of some transactions and 0 percent taxation of others gives rise to a highly complex and widely varying pattern of effective tax burdens across industries. Much of the variation in effective tax rates is evidently attributable to the complex patterns of interindustry trade. Refining these calculations by accounting more precisely for some of the added complexities of Kentucky's actual tax structure would change the numerical values of the estimates in Table 4. More precise calculations would not, however, overturn the essential finding that Kentucky's existing tax system produces a complex and arbitrary pattern of taxation among commodity categories.

For the reasons outlined in Chapter 1, wide variations in effective tax rates create fiscal incentives that encourage some types of production and consumption while discouraging others, giving rise to economic inefficiencies. The economic incidence or distribution of the tax burden, though virtually impossible to estimate with precision, would also exhibit similar wide and apparently quite arbitrary variations. To some degree, heavy rates of taxation of some industries may shift tax burdens back to workers and firms engaged in these industries, rather than forward onto consumers, and this also can affect the equity of the distribution of tax burdens. For example, economic activity in some localities or regions within the state may be relatively heavily oriented toward manufacturing industry, whereas services account for a larger fraction of employment and investment in other regions. The figures in Table 4 suggest that the cascading of tax burdens on tangible goods may reduce employment and investment, and possibly wages and some other sources of income, for the former groups relative to the latter.

A CONSUMPTION TAX?

Kentucky's sales tax could be reformed in a number of ways. Perhaps the most important potential reforms relate to the definition of the tax base. Should existing exemptions be repealed, or expanded? Would it be a good idea to include intangibles, or should they continue to be excluded? Can use taxes be effectively imposed on consumers, whether for tangible goods or for intangibles?

As we have seen, if the goal of the sales tax is to achieve a reasonable approximation to a uniform tax on all consumption by Kentuckians, the existing sales tax leaves much to be desired. In some respects, the sales tax is too narrow, and should be broadened. In other respects, it is too broad, and should be narrowed.

Broadening is needed in two main respects. First, consumption of intangibles should be subject to tax. This would include health care services and many other items of consumption that some might argue should be left untaxed on equity grounds. It would also include purchases of intangibles from out-of-state suppliers, including electronic content of various forms (online entertainment, software, and consumer services). Second, out-of-state consumer purchases of tangible goods should be taxed. This part of consumption is already taxed, in principle,

under the use tax. Practically speaking, however, this part of the tax is widely ignored, preventing uniform application of the sales tax to all forms of consumption.

Narrowing of the tax base is also needed. Businesses that sell tangible goods to in-state businesses are presently subject to tax, except where exempted. These exemptions help to mitigate the cascading of tax burdens on tangible goods, but they apply nonuniformly. The goal should be to remove all effective tax burdens on business-to-business sales.

It is one thing to state these objectives and quite another to achieve them. From the viewpoint of tax administration, compliance, and enforcement, there are several serious obstacles that stand in the way of uniform taxation of consumption. The difficulties involved in enforcing use tax compliance are well known and need not be discussed at length here. Kentucky is certainly not unique in its struggle to tax mail-order, Internet, and other interstate purchases by consumers. The best hope for progress in this area might lie in coordinated efforts by many states to improve, standardize, and simplify use tax reporting and enforcement.

A more difficult problem is that of distinguishing between sales to consumers and sales to businesses so as to focus the burden of the sales tax on the former and to avoid taxation of the latter. There are at least three possible approaches to this problem, two of which involve systematic extensions of existing policy.

At present, a vendor does not (in general) distinguish between sales to consumers and sales to businesses; if a sale is taxable, it is generally taxable regardless of the identity of the purchaser. However, sales to nonprofit institutions, governments, educational institutions, and certain other classes of purchasers are exempt from sales tax. Administratively, one way to allow for these exemptions is to provide tax-exempt purchasers with some means to identify themselves to vendors and thus to escape the imposition of sales tax at the time of purchase. In principle, this procedure could be carried out more widely, by allowing all businesses to identify themselves as tax-exempt purchasers, thereby obviating the sales tax burden on intermediate goods transactions.

Alternatively, rather than providing exemptions by type of purchasers, one could allow for exemptions by type of commodity. This is exemplified, in current policy, by the exemption not only of the sales of services, but of many specific tangible goods, including food, prescription drugs, coal used for the generation of electricity, tombstones, horses, and ratite birds (ostriches, emus, rheas, kiwis, and cassowaries), to name only a few. One could attempt to identify and exempt from taxation those types of goods and services that are sold exclusively or primarily to businesses.

A third approach, widely practiced in the rest of the world, is to insist on the collection of tax on all sales, without regard to the identity of the purchasers, but to allow businesses to reduce the tax liability on their sales by applying a credit for taxes paid on any purchases that they make from other businesses. This is one method of administering a value-added tax (VAT), so-called because it effectively exposes a business to taxation on the value of its sales minus the value of the purchases it makes from other businesses, i.e., the value that it adds in the production process. Although a VAT is imposed, administratively speaking, at every stage of the production process, all the way to final sales to consumers, the crediting for

taxes paid at prior stages in the process prevents the tax from cumulating or cascading. In the end, the VAT is economically equivalent to a tax on final consumption.

Each of these approaches presents a number of administrative challenges and none of them could be expected to function perfectly. Exemption of all sales other than to final consumers is perhaps the simplest approach, at least superficially. The implementation of a VAT would represent the boldest departure from existing U.S. practice, but there is considerable administrative experience with VATs around the world. The most challenging administrative problems with a VAT are likely to arise with respect to taxation of interstate transactions where border formalities cannot be permitted to interfere with the free flow of commerce. The exemption of particular commodities, an important characteristic of current policy, does not "cleanly" distinguish between sales to final consumers and sales to businesses. Conceivably, it can be justified as a workable practical solution when applied judiciously to those commodities that are purchased predominantly by businesses. The exemptions found in current policy certainly do not reflect any systematic attempt to identify these commodities, however. Rather, they appear to have accumulated, on a piecemeal basis, in response to representations on behalf of particular interests.²²

From an administrative viewpoint, perhaps the simplest reform of the sales tax would be to remove all exemptions and to tax, at a uniform rate, all sales of all goods and services to all purchasers. This would seemingly provide the broadest base and would produce the most revenue for any given rate of taxation. Though simple, this reform would likely impose severe efficiency costs on the state's economy. It would, in effect, convert the sales tax to a turnover tax, with the adverse efficiency and equity consequences noted previously.

CONCLUSION: ROOM FOR IMPROVEMENT?

The sales tax is an important revenue source not only for Kentucky but for most U.S. states. Because it applies *relatively* uniformly to a *relatively* broad base, it permits revenue to be raised with less damage to economic efficiency than some other possible taxes. However, Kentucky's sales tax is still far from uniformly applied to all consumption. As a result, some types of consumption are effectively taxed at quite high rates, while other types escape most of the burden of the sales tax. Can the sales tax be improved? The answer is surely yes, but reforms must be undertaken with care.

First, attempts to achieve more uniform taxation of consumption must confront significant administrative obstacles. A simple-minded approach to base broadening would remove existing exemptions for services without addressing the problem of cascading of tax burdens through taxation of intermediate-goods

²² The Kentucky Revenue Cabinet publishes *Kentucky Tax Facts*, a summary of all major tax provisions in the state. The section on sales and use taxes lists no fewer than 60 categories of exemptions, many of which, like that for ratite birds, include many more specific commodities.

transactions. Such an approach could well do more harm than good from the viewpoint of economic efficiency.

Second, more uniform taxation of all consumption, even if administratively feasible, does not necessarily constitute a policy improvement. In particular, more uniform taxation, while possibly efficiency enhancing, might be objectionable on equity grounds. Exemptions for sales taxes on food, for example, are commonly defended on vertical equity grounds, since food expenditures tend to fall as a fraction of income as income rises. Of course, there are other ways to provide tax relief to low-income households (for example, by taxing income rather than consumption), and most careful economic analyses in fact suggest that tax relief for the poor is usually not very effectively promoted by differential taxation of different types of commodities. Exemptions for health care services or prescription drugs might be justified on ability-to-pay grounds or because consumption of these commodities is seen as particularly meritorious. It is worth bearing in mind, however, that alternative and quite possibly superior policy instruments may be available to promote these goals. For example, explicit subsidies for particular kinds of health care services (for cancer treatment, perhaps, but not necessarily for treatment of sports injuries) or for particular kinds of drugs (brand-name vs. generic variants of drugs) might be more effective at promoting health goals than a sales tax exemption, the benefits of which are in any case limited by the sales tax rate.

While vertical equity and ability to pay considerations might be used to justify existing tax preferences in the sales tax, horizontal equity would be promoted by removal of these preferences. Indeed, many of the arguments advanced in favor of specific tax exemptions or other tax preferences, properly understood, actually illustrate the harm that these policies can create. For example, industry-specific exemptions are frequently advocated or defended because of their ostensible impacts on employment in particular industries or on the economies of particular regions. Such effects illustrate precisely how fiscal incentives cause resource misallocation: tax inducements that cause particular industries to expand also cause other industries to contract, and scarce labor, capital, land, and other resources are driven away from their most productive uses into less productive ones. They also illustrate how specific tax preferences can benefit some groups at the expense of others, very possibly creating inequities rather than alleviating them.

The issue of sales tax reform well illustrates how efficiency, equity, and administrative considerations can come into play simultaneously in policy analysis. There is no unambiguous scientific principle that can dictate how these conflicting considerations should be weighed. On balance, since the current system of sales taxation results in considerable and rather arbitrary differences in effective rates of taxation on different commodities, it is reasonable to conclude that efficiency-oriented reforms targeted at more uniform taxation of final consumption deserve further consideration. The development of more complete reform proposals would require additional detailed technical analysis, however.

4

TAX EQUITY IN KENTUCKY

Family Tax Burdens and the Question of Fairness

By Charles W. Martie

The interpretation of fairness is largely subjective. Nevertheless, some broad principles emerge. Kentucky's state and local tax system carves out significant exemptions on necessities and provides income tax credits for the very poor. The tax burden is fairly proportional over most income ranges except the upper-income levels, where it is somewhat regressive. Addressing inflation, which has robbed Kentucky's income tax of its progressivity, would enhance vertical equity. However, Kentucky's skewed income distribution presents unique challenges to significant tax reform. Horizontal equity issues remain complex but Kentucky's many exemptions and exclusions that riddle its large taxes create opportunities to promote equitable and efficient tax policy.

Traditional studies of tax equity have concentrated on the ability of citizens to pay their share of the tax burden. It is easy to discern differences in ability to pay as one drives through the Commonwealth, passing from gated-estate communities to high-density starter-home neighborhoods, from small community mobile home parks to urban public housing complexes, and from small-town neighborhoods to single-family farms. Drive Route 460 through Georgetown and out into the countryside and you'll experience the skewed bell curve of Kentucky's income distribution, which reflects its demographics, economy, and past investments in education.



The author thanks John Scott, Wendell Butler, Michael Jones, Mary Lassiter, and Charles Schroff for their assistance on this project. The views expressed in this chapter are solely those of the author and do not necessarily represent the position of the Governor's Office. Errors are, of course, the sole responsibility of the author.

The question at hand is how state and local taxes affect the distribution of income available for private spending. Most equity studies look at ability to pay as the basis for assessing the equity of taxes. This chapter looks at various studies done in the past and examines the impact of state and local taxes on Kentucky households across various measures of ability to pay. The chapter also discusses the effects of various exemptions and credits and changing technology on tax equity.

The price of equity is also relevant in any discussion of tax modernization. If fairness were cheap, we'd likely see more of it; however, altering the equity of a tax system always requires sacrifices. How much is Kentucky willing to pay in order to improve the equity of its tax system? This chapter looks at the cost of providing tax relief to low-income households in light of Kentucky's current income distribution.

Finally, the chapter examines the effect of changes in economic factors on the incidence of Kentucky's taxes. For example, failure to index rate classes in the individual income tax has dramatically altered the size and burden of the tax. The implication is that the current incidence of the income tax is not necessarily the result of consistent attention to and tinkering with Kentucky taxes, but rather, the rigidity built into the taxes as originally enacted.

DEFINING TAX EQUITY

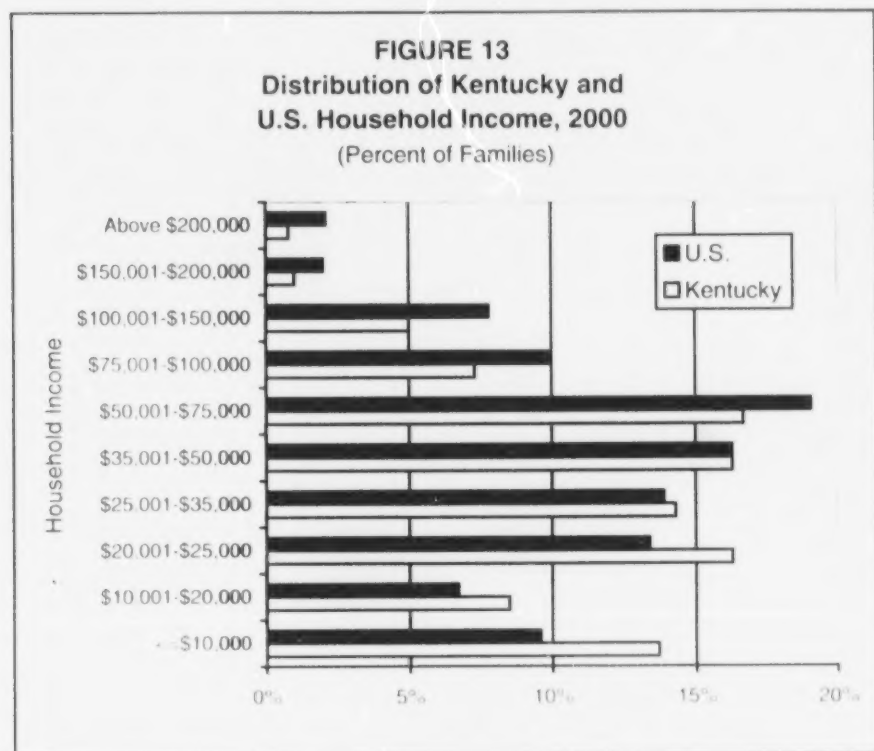
It has become popular practice in matters of tax reform to attach the principles of fairness and equity, as in, "the resulting tax systems should be fair and equitable." This practice raises suspicions that fairness and equity are not substitutes. Fair is defined as just, impartial, or being in accordance with rules, logic, and ethics. Equitable is defined as fair, just, or impartial. Fairness in popular usage connotes the latter meaning, in the sense of a fair shake, that somehow, for example, tax agents are not singling you out for bad treatment. This is essentially the meaning of impartiality, although tax agents can impartially give all persons bad treatment, which no one would consider just or fair. Justice suggests blindness to individual differences, but often hinges on the facts of individual cases. From here on, I'll use equity to embrace all such related concepts of fairness, justice, and impartiality.

The public finance literature has popularized two definitions of equity: vertical and horizontal. Vertical equity concerns how government affects persons who differ in ability to pay and is typically discussed in terms of burdens of government across income levels. Horizontal equity, equal treatment of equals, is generally accepted as an outcome of broad-based tax and expenditure systems, whereby two "equal" taxpayers can't legally pay different tax liabilities solely because of some differences in their spending, saving, or investment actions. Both concepts present opportunities for comprehending optimal tax systems, but also considerable definitional and operational hurdles.

REDISTRIBUTION IN A POOR STATE

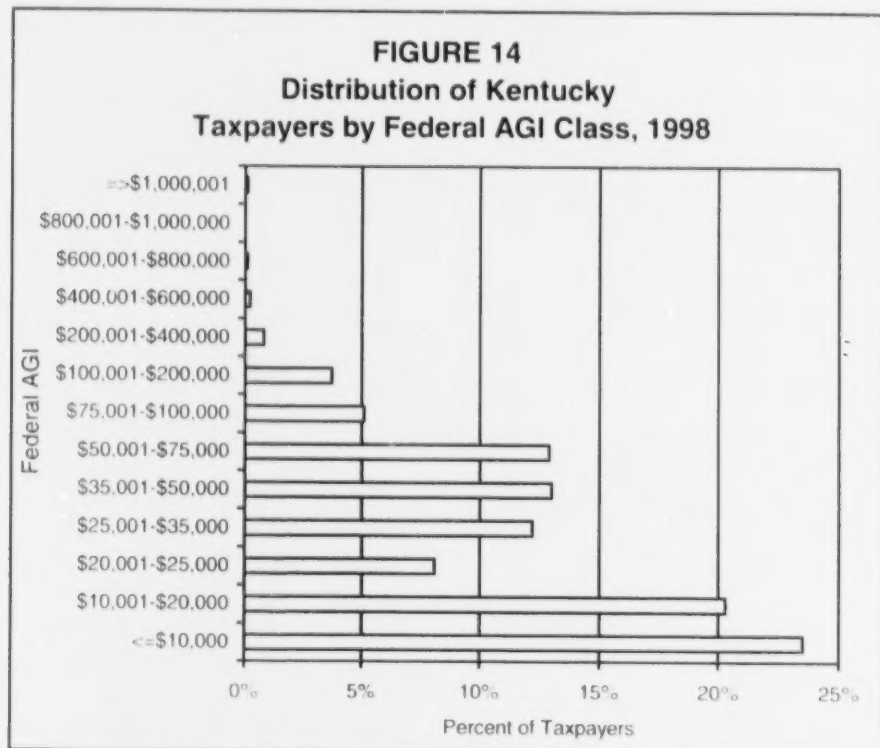
The current distribution of income among income taxpayers in Kentucky is shown in Figure 13. According to the Census 2000 Supplementary Survey,²³ average household income in Kentucky was \$42,852 vs. \$55,253 for the United States. The median Kentucky household earned \$32,843 compared with \$41,343 for the U.S. household. These income figures include most sources of income including some transfers such as Temporary Assistance for Needy Families (TANF) and food stamps. Kentucky's median income was the fifth lowest in the nation.

These data reveal the distinct nature of Kentucky's income distribution: 39 percent of Kentucky households earn less than \$25,000 compared with 30 percent for the nation as a whole. To put this in perspective, to make the low end of Kentucky's income distribution like the average state, Kentucky would have to lift 140,000 families above \$25,000. Kentucky at the high end is no different: 7 percent of Kentucky households earn more than \$100,000, compared to 12 percent across the nation. To match the high end of the distribution of the average state, Kentucky would have to lift 83,000 households over the \$100,000 threshold. The middle of the distribution is disturbing as well; if one considers "middle class" to be \$35,000 to \$75,000, Kentucky's middle-class is missing 37,000 households.



²³ Available at <<http://factfinder.census.gov/home/en/c2ss.html>>

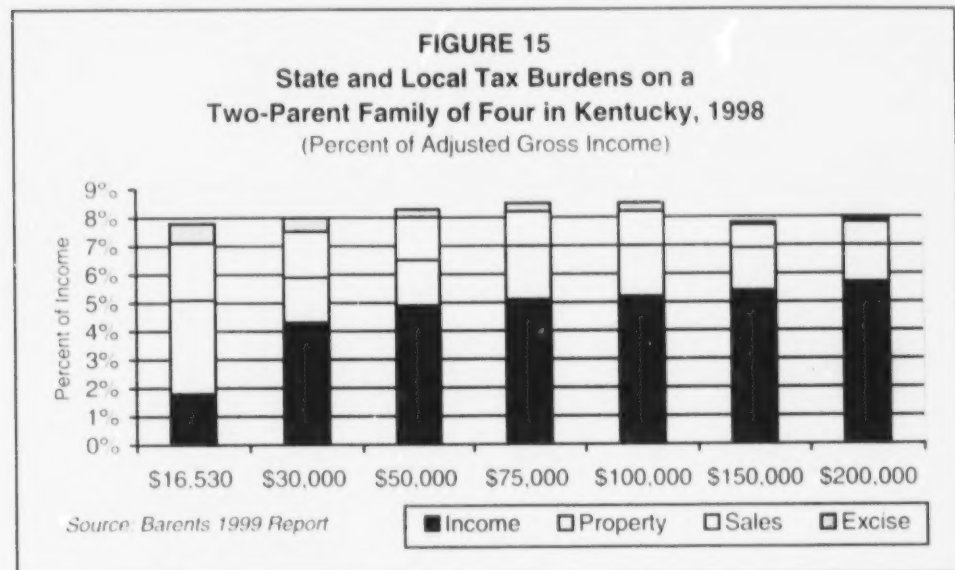
The distribution of Kentucky taxpayers by federal adjusted gross income (AGI) shows a similar pattern (see Figure 14). Effectively half of Kentucky taxpayers have an AGI of less than \$25,000. As a result, the bottom 80 percent of taxpayers pays 37 percent of income tax and the top 4 percent pay 30 percent of income tax. It is a simple matter to show that redistributing \$100 to taxpayers earning less than \$25,000 would cost \$1,400 per taxpayer earning over \$100,000. Targeting those with incomes greater than \$200,000 would require a \$6,000 increase in their income tax bills. Whether the level of inequity in the current tax system warrants such a change is a matter for policy debate.



BURDEN STUDIES OF KENTUCKY TAXES

Recent years have produced several studies of state and local tax burdens. Because of the effort involved in calculating incidence of individual taxes across 50 states, most of these studies have focused on the average burden or tax effort. However, two studies have provided burden estimates by income classes across multiple states. Both studies use income measures that exclude transfers. As a result, effective tax rates are overstated at low-income levels relative to measures of true ability to pay. Similarly, neither study includes the imputed rent to home ownership as income, thereby overstating effective rates across middle- and upper-income classes. Furthermore, the studies focus on families rather than households, thus failing to represent, among others, single households and the elderly.

The 1999 Barents study estimated the effect of Kentucky state and local taxes on families of four at various income levels.²⁴ The results are shown in Figure 15. Kentucky's tax structure consumed about 8 percent of income no matter where one falls in the income distribution. A moderate amount of progressivity occurs for low-to-middle income families, which diminishes at high-income levels. The income tax is moderately progressive, while sales and excise taxes are regressive. The mix of property taxes is fairly proportional over all but the lowest income classes.

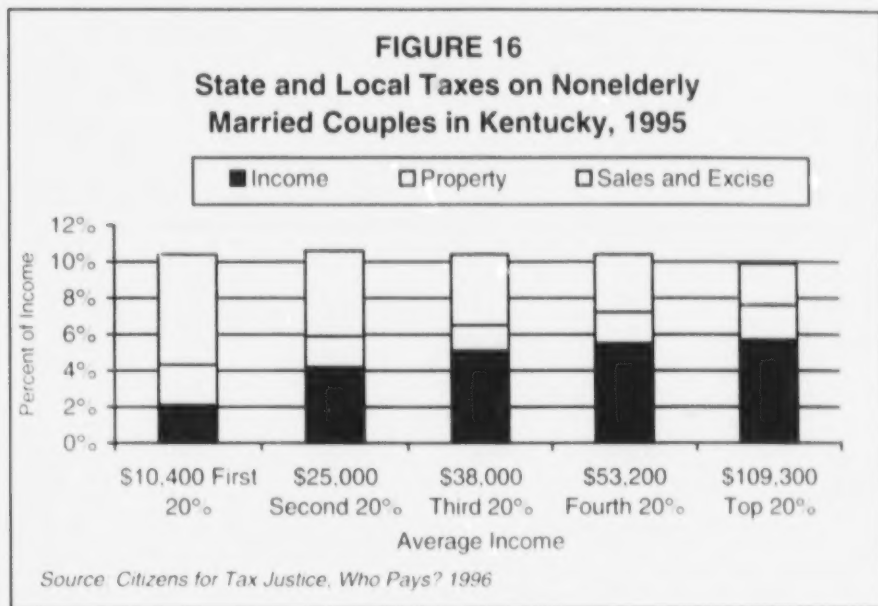


In 1996, the Citizens for Tax Justice published a 50-state analysis of state and local tax systems that assessed the burden of the major taxes by income quintile.²⁵ The study used fairly standard incidence assumptions and methodology in deriving effective tax rates for nonelderly married couples in 1995. The data on property taxes is outdated, failing to reflect the significant exemption of intangible property precipitated by the *St. Ledger*²⁶ decision and reductions in motor vehicle property tax valuation since 1995. Taking those changes into account would lower Kentucky's property tax burdens across the board. The results for Kentucky are shown in Figure 16. The data show that Kentucky's state and local tax system is essentially proportional to income across all but the highest-income class. Kentucky taxes take approximately 10 percent of household money income, with the progressivity of the income tax offset by regressivity in sales and excise taxes.

²⁴ Barents Group LLC, *Comparative Analysis of Kentucky's Tax Structure* (Washington, DC: Author, 1999) 71-80.

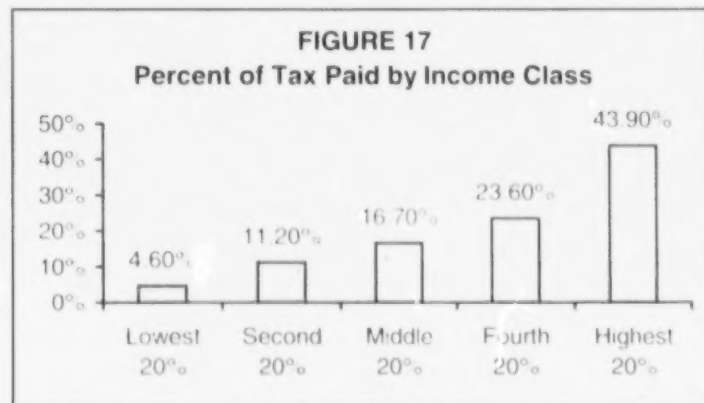
²⁵ Michael P. Ettlinger, John F. O'Hare, Robert S. McIntyre, Julie King, Neil Miransky and Elizabeth A. Fray, *Who Pays? A Distributional Analysis of the Tax Systems of All 50 States* (Washington, DC: Citizens for Tax Justice, 1996).

²⁶ *Hershel St. Ledger et al. v. Commonwealth of Kentucky*.



The two studies paint a similar picture for Kentucky state and local taxes. The tax system is fairly proportional over most income ranges except the upper-income levels. A flat income tax, heavy reliance on sales taxes, and low property taxes contribute to this outcome.

While effective tax rates are instructive, they also require some interpretation. The burden of taxes is generally spread proportionally across income, but the same is not true across households. Figure 17 uses the data on effective rates and income by quintile to calculate the taxes paid by quintile. The data show that the richest 20 percent of Kentucky households pay 43.9 percent of state and local taxes, while the poorest 20 percent pay 4.6 percent of taxes. Essentially, the average household in the highest quintile pays as much tax as 10 poor households put together. Again, the question of whether this is too high or too low depends on one's view of vertical equity.



COMPARISONS WITH OTHER STATES

These studies are useful as well in assessing how Kentucky stacks up against other states. Using the data from the Citizens for Tax Justice study, Kentucky's overall tax burden on the lowest quintile ranks 37th highest in the nation.²⁷ Kentucky's ranking by tax types is shown in Table 5 (1 = highest burden). The data reveal why advocates for working poor families give Kentucky's personal income tax significant scrutiny. Taking into account the property tax changes mentioned earlier would lower Kentucky's property tax rankings even further. Kentucky's sales tax burden ranks below the median state for nearly all Kentuckians.

TABLE 5
How Kentucky Ranks in the United States
Based on the Citizens for Tax Justice Study

Income Quintile	General Sales Tax	Total Property Taxes	Personal Income Tax	Total Taxes
Lowest 20%	30	46	11	37
Second 20%	32	40	5	13
Middle 20%	32	39	5	12
Fourth 20%	30	36	5	8
Next 15%	30	32	4	9
Next 4%	29	30	8	12
Top 1%	14	39	16	20

Source: Citizens for Tax Justice, 1996

Table 6 shows how Kentucky ranked among 16 competitor states in the Barents study.²⁸ A pattern similar to the Citizens for Tax Justice study emerges. Kentucky's exemption-rich sales tax and moderate property taxes soften much of the burden on very low-income earners but fail to compensate for the relatively high income tax on the lower- to upper-middle class. The low-income credit provides relief for the very poor but fails to cushion what might be called the working poor from much of the 6 percent income tax rate.

TABLE 6
How Kentucky Ranks in the South: Barents Study

Income Level	Sales Tax	Property Tax	Personal Income Tax	Total Taxes
Poverty Level	15	6	3	7
Twice Poverty Level	15	6	1	3
\$30,000	15	6	1	3
\$50,000	15	7	1	4
\$75,000	15	7	1	4
\$100,000	15	7	1	3
\$150,000	13	7	3	4
\$200,000	13	7	3	4

Source: Barents 1999 Study

²⁷ Citizens for Tax Justice

²⁸ Barents

VERTICAL EQUITY OF THE INCOME TAX: A PROBLEM OF INDEXING

Analyzing trends in tax equity can be revealing. The equity of tax systems change over time because of incremental exemptions, rate changes, court-driven exclusions, and exemptions and deductions that weren't indexed to inflation. In fact, some of the worst criticism of Kentucky's tax codes concerns its failure to adjust to changing costs of living.²⁹ Rate classes, low-income credit thresholds, and personal credits have largely remained at their original levels.³⁰ The current rate brackets, rising from 2 percent on the first \$3,000 of taxable income to 6 percent of income above \$8,000, are as they were in 1950 when per capita income in Kentucky was \$990.³¹ The effect has been to remove a large degree of progressivity from the tax. The low-income credit, established in 1990, remedied some of this problem, but the failure to index its thresholds has weakened its effect over time.

In order to discern the magnitude of the effect of nonindexing on tax burdens, we calculated what the current income tax brackets, credits, and standard exemption would be had they been indexed to the Consumer Price Index in the year they were established. Table 7 compares the current law with this hypothetical indexed law. The most notable result is that the 6 percent marginal tax rate would start at \$57,000 rather than the current \$8,000. Families with taxable income less than \$35,000 would face only a 4 percent marginal rate. Furthermore, the standard deduction would be \$2,700 larger, and a family of four would receive \$380 more in personal tax credits.

TABLE 7
Kentucky's Income Tax: Current Law (2000) vs. Indexed

Tax Rate Brackets	Rate	Current Law	Indexed Law*
		Taxable Income Range	
	2%	\$0-\$3,000	\$0-\$21,422
	3%	\$3,001-\$4,000	\$21,423-\$28,563
	4%	\$4,001-\$5,000	\$28,564-\$35,704
	5%	\$5,001-\$8,000	\$35,705-\$57,126
	6%	over \$8,000	over \$57,126
Low-Income Tax Brackets	Rate	AGI Range	
	100%	\$0-\$5,000	\$0-\$6,595
	50%	\$5,001-\$10,000	\$6,596-\$13,190
	25%	\$10,001-\$15,000	\$13,191-\$19,786
	15%	\$15,001-\$20,000	\$19,787-\$26,381
	5%	\$20,001-\$25,000	\$26,382-\$32,976
	0%	over \$25,000	over \$32,976
Standard Deduction		\$1,700	\$4,419
Personal Credits		\$20	\$115

*This is a hypothetical law. If the tax rates were indexed to the Consumer Price Index (CPI), these would be the resulting income ranges associated with each tax rate.

²⁹ For a recent study of the burden of state personal income taxes, see Center on Budget and Policy Priorities, *State Income Tax Burdens on Low-income Families in 2000* (Washington, DC: Author, 2001).

³⁰ The pension exclusion threshold adopted in 1997 is indexed for inflation as is the standard deduction starting in 2001.

³¹ The Census Bureau estimates Kentucky per capita income in 2000 at \$17,324.

The effects of indexing were derived using the Individual Income Tax Microsimulation Model, which uses a large sample of tax return data to calculate tax liabilities of Kentucky taxpayers under the current law and under various tax code changes. As one would expect, one primary effect of indexing is to remove substantial numbers of taxpayers from the tax rolls. Of 1.4 million currently taxable returns, 188,000 would show no tax liability; 170,000 of these returns had less than \$20,000 in taxable income.

Other effects include doubling the total amount of credits taken, a \$130 million increase, increasing deductions by \$3.4 billion, or 42 percent, and reducing the number of itemizers by 200,000. However, the fiscal impact of this degree of indexing is enormous, reducing income tax revenues by \$1.2 billion, or 47 percent. Because it is unrealistic to assume the state would have reduced revenues by \$1.2 billion, it is necessary to adjust the figures to keep the changes revenue neutral. The state would likely have substituted other tax revenues for at least some of this loss in income tax. The overall effect on tax burdens depends heavily on how this revenue would be raised. For simplicity and because the overall incidence of state taxes tends to be fairly proportional, the analysis makes up the \$1.2 billion through a tax that is proportional to income.

Table 8 shows how indexing and proportional taxation affect the average tax paid at various income levels. For Kentuckians in the lowest income class, the new tax system would actually be more onerous than the old one. This results because this income group pays very little income tax, mostly due to the low-income credit. Indexing further reduces their tax, but replacement of the lost revenue through proportional taxation is particularly burdensome. This is not just a theoretical exercise; local governments throughout Kentucky have increasingly turned to occupational taxes to augment their budgets. These local income taxes grew 86 percent from 1992 to 1999 compared with 51 percent for Kentucky state income taxes and 55 percent for local governments across the nation. Many of these taxes are strictly proportional to income and offer no deductions or credits.

TABLE 8
Effect of Revenue-Neutral Indexing by Income Class

AGI Class	Per Capita Tax (\$)		
	Current	Indexed	Difference
\$0-\$10,000	30	80	50
10,000 to 20,000	430	309	-121
20,000 to 30,000	1,007	642	-365
30,000 to 50,000	1,654	1,201	-453
50,000 to 75,000	2,672	2,218	-454
75,000 to 100,000	3,807	3,517	-291
100,000 to 200,000	5,792	6,187	396
Above 200,000	21,114	33,008	11,894
Total	1,729	1,729	0

Source: GOEA microsimulation model calculations.

The working poor fare better under indexing and do so even under revenue neutral taxation. The same holds true for households with incomes up to

\$100,000. This result shows the effect of lower tax rates over more of their income and significant deductions and credits.

Households with income between \$100,000 and \$200,000 fare worse, but only marginally so, as proportional taxation eats up the benefit of large itemized deductions in the income tax. The highest-income group is made significantly worse off, with their average tax bill rising by more than a third.

This extreme example of full indexing of income tax thresholds and credits is a theoretical exercise to show the effects of nonindexing on the incidence of the tax. Because the indexed tax generates so little revenue, it is unlikely that the current rate structure would have remained. Nonetheless, the same analysis could be extended to various scenarios of indexing, rate structures, and revenue capabilities. The results would be the same: most Kentuckians would have been better off, and the tax system would have been more progressive at the high end, if the income tax had been indexed and augmented with a proportional tax.

THE EFFECTS OF INFORMATION TECHNOLOGY ON EQUITY: THE DIGITAL DIVIDE

Advances in information technology have also raised equity concerns for state and local governments. Recent estimates of the avoidance of sales tax and the subsequent evasion of use tax facilitated by the Internet suggest that Kentuckians will reduce their tax burdens by \$84 million dollars per year in 2001, rising to \$286 million in 2006.³² Internet purchases require certain assets that are not distributed evenly across the income distribution including computer hardware, software, Internet access, credit cards, and secure points of delivery. The Kentucky Long-Term Policy Research Center found that computer ownership and Internet access were strongly related to income.³³ Among those Kentuckians who have made online purchases, only 4.8 percent have incomes under \$20,000 a year. By contrast, one third of online shoppers in the Commonwealth reported annual incomes over \$50,000. The equity issue at hand is whether the Internet provides substantially more opportunities to evade taxes for certain taxpayer groups. This so-called "digital divide" makes the sales and use tax more regressive than it has been in the past. Because this change in the burden was largely precipitated by changes in technology rather than public policy, it can be viewed as a deviation from the desired incidence of the tax. Addressing sales and use tax evasion is a complex federalist issue involving court decisions, the Interstate Commerce Clause, and congressional agendas.

The degree of the equity problem is not yet known. Some would argue that these discrepancies in the ability to shop across state lines have existed for years;

³² Donald Bruce and William F. Fox, *State and Local Tax Revenue Losses from E-Commerce: Updated Estimates* (Knoxville, TN: Center for Business and Economic Research, University of Tennessee, 2001) 8-9.

³³ Michal Smith-Mello, Michael T. Childress, Amy L. Watts and John Watkins, *Challenges for the New Century*, (Frankfort, KY: Kentucky Long-Term Policy Research Center, 2001).

the recent boom in business-to-consumer (B2C) transactions has merely aggravated a long-standing problem. Furthermore, of the \$84 million in 2001 e-commerce use tax evasion, 90 percent is estimated to be from business-to-business (B2B) transactions.³⁴ As a result, it is clear that having Internet access is not the only means of benefiting from use tax evasion; one merely has to purchase goods from firms that keep costs of inputs low by evading their business use tax liabilities. As such, it is likely that the extent of the equity problem caused by the digital divide is fairly small. However, any tax subject to increasing opportunity for evasion, regardless of equity considerations, should be addressed as a policy concern.

HORIZONTAL EQUITY CONCERNS

TTrue horizontal inequities can only be discerned when comparing individuals or households in similar situations. If person A and person B start out in the same place, make similar decisions, and yet witness significantly different results (on average), some horizontal inequity exists. In Kentucky, the question of horizontal equity has arisen in several parts of the tax code. Here are but a few examples.

PRESCRIPTION DRUGS

Kentucky sales and use tax currently exempts drugs prescribed by a physician and dispensed by a registered pharmacist, an exemption valued at approximately \$170 million. In the case of an individual consuming prescription drugs administered at a doctor's office or nursing home, there is a sales tax liability. A court decision in the *Humana*³⁵ case introduced a second issue: for-profit hospitals with their own pharmacies are now exempt when they administer drugs, while doctor's offices, and nursing homes, remain taxable. Let us discuss these two issues in turn.

Self- vs. Provider-administered Drugs. Whether this is horizontally inequitable depends on whether the good consumed is the same. If the drug is administered at the doctor's office, presumably this is the case because the service of a trained professional conveying the drug has some value. It may well be that in the absence of a controlled environment for administering the drug, this treatment may have little value or, in fact, be harmful to the patient, in which case the drug imposes a cost on the patient. Separating the value of the drug itself from the value of administering it properly raises efficiency and compliance questions that would likely swamp equity concerns. Furthermore, if professional administration of drugs is strongly correlated with the type of disease, e.g., diabetes, cancer, renal disease, the tax code discriminates by disease. This outcome is unsavory but will arise whenever certain transactions are exempted from a tax base. The relevant question is whether the efficiency concerns associated with proper determination of the market value of the good vs. the service outweigh the equity concerns.

Hospitals vs. Nonhospitals. It is difficult to defend the concept that the taxability of administered drugs should depend on the nature of the provider institu-

³⁴ Bruce and Fox 6, and author's calculations.

³⁵ *Revenue Cabinet v. Humana, Inc.*, (1997-CA-000568-MR).

tion. Logically, hospitals are collections of provider offices that differ from individual providers' offices in scale and scope. The nature of the product is the same. Furthermore, the distinction between a hospital and a nursing home is at best a blurry one in terms of the nature of the product provided. As such, it is likely that the current tax law as it pertains to prescription drugs has horizontal equity problems. This example also underscores the difficulties presented by attempts to enhance vertical equity in the tax code as well as the complexity of tax administration.

PENSION INCOME

The exclusion of pension income from the individual income tax also raises equity concerns. First, it treats retirees with different sources of income differently, favoring those households who saved for retirement by means of a pension or IRA relative to those who acquired stocks, bonds, real estate, or other assets, whose income or capital gains realization will be taxed. The farmer or small business owner who re-invested his or her savings into the business receive no such exemption. Furthermore, the exclusion provides current retirees a tax savings with a higher present value than those who will retire in future years, thus creating some intergenerational inequity.

ENTERPRISE ZONES

Currently, Kentucky provides sales, corporation, and motor vehicle usage tax exemptions to certified businesses located in any of 10 designated zones scattered throughout the state. Furthermore, residents and uncertified businesses located in the zone can receive sales tax exemptions for building materials purchased. Current laws limit the number of zones to the existing ten. Several expansions of the existing zones have occurred in order to provide the tax incentive to more businesses. The result has been that two businesses located one block apart will face different costs of production and expansion because of these exemptions. Also, one family residing over the line from Knox County, for example, will pay 6 percent more for lumber and building supplies for renovating their home. In 1992, an Attorney General's opinion declared portions of the enterprise zone statute unconstitutional. The opinion declared that limiting the number of zones to ten was unconstitutional on the grounds that it violated the Constitution's ban against special legislation favoring certain jurisdictions over others. These opinions do not carry the force of law.

Overall, we are left with some clear-cut horizontal equity problems and others that raise questions. However, if the general principle holds that the narrower the tax base, the greater the likelihood and severity of horizontal inequities, a comparison of Kentucky's tax base with other states should provide some guidance. Kentucky ranks somewhere in the middle of other states and has shown a recent trend toward narrowing the base. According to calculations by Bruce and Fox,³⁶ Kentucky's sales tax base in 1995 was 46.5 percent of personal income, which means that of 45 states imposing a sales tax, 19 states have a narrower base than

³⁶ Bruce and Fox 4.

Kentucky. In the decade of the 1990s, Kentucky added or expanded 22 exemptions to the sales tax.

ISSUES IN ASSESSING EQUITY

Analysis of equity isn't straightforward. Even if we can all agree on the effect of taxes in the economy, there are several issues to tackle before discerning the appropriate reform. A few of these issues are addressed here.

Vertical Equity. Difficulties in assessing vertical equity arise in many aspects. First, effective rates of taxes across income classes vary substantially depending on the definition of income used. In a study of 1991 Census data, Browning estimates the ratio of the average income for the highest quintile to the average income of the lowest quintile.⁵⁷ The ratio for before-tax and before-transfer money income is 12.1. The ratio after taxes and some in-kind and cash transfers is 8.4. Finally, adjusting for differing household sizes across income levels (more singles in the low quintile) yields a ratio of 5.1. All ratios indicate a substantial level of income inequality; however, degree of inequality varies tremendously. Since vertical equity requires some judgment of how much inequality is preferred, agreement upon the income measure is critical.

The above analysis uses annual income as a measure of ability to pay. Because many households in the low-income quintiles consist of college students, the elderly, and young workers, current annual income will understate their lifetime ability to pay. As a result, their effective tax rates will appear higher than they really are. Students will spend out of future income and the elderly will spend out of past income, thus raising their sales, property, and excise tax burdens in any given year. Correcting for this problem reduces the regressivity (or raises the progressivity) of these taxes.

Even if policymakers can agree on the definition and term of income to be used as a base for the burden study, they may reach vastly different conclusions about appropriate reform, depending on their perception of fairness. Scholars suggest that people's perception of vertical equity is altered by their current status and that uncertainty about future income increases the call for a more even distribution. Economists theorize that redistribution provides a public good beneficial to all of society, and that public sector redistribution of income can successfully augment private charity. However, none of these arguments guide policymakers in determining the *optimal* amount of vertical equity.

Horizontal Equity. Discerning whether equals are treated equally, of course, hinges on the definition of equality. Typically, equity studies treat two parties as equals if they have equal incomes. The Smiths and the Joneses may have identical incomes, identical 3-bedroom ranches on identical streets, live equidistant from the elementary school where their children attend, drive the same late-model Toyota cars and vote conservatively in all elections. Horizontal equity requires they pay the same amount in taxes. However, if the Smiths and the Joneses are equal, then any tax system will treat them equally, because they will make identical con-

⁵⁷ Edgar K. Browning, *Public Finance and the Price System*, 4th ed. (Englewood Cliffs, NJ: Prentice-Hall, 1994) 259.

sumption, labor supply, investment, and savings decisions. Even a state-enacted hodgepodge of loopholes and preferences, as long as it doesn't include anti-Smith or anti-Jones taxes, will yield equal burdens. No help so far, but this scenario is an unreasonable burden for the concept of horizontal equity to bear.

More realistic is the notion that Smith and Jones appear equal, but their different economic choices yield different tax burdens. Jones avoids some sales tax by raising ostriches and Smith, some income taxes by sending his children to pre-school. Jones eludes some property taxes by buying a used car, and Smith, some excise taxes by switching from cigarettes to smokeless tobacco. The myriad exemptions yield unequal taxation of what began as equal incomes, and are thus, inequitable.

Upon closer examination, however, we find that the equality of their incomes ends at the dollar measure. The Smiths' \$50,000 income comprises her \$30,000 salary, his \$19,000 salary, and \$1,000 interest from a savings account, while the Joneses get \$55,000 per year from interest on an inheritance minus the \$5,000 annual loss from the ratite business that has yet to take off, so to speak. The Joneses play golf and tennis four times a week and enjoy gardening, wiffle ball with their children, and long walks in the park. The Smiths go grocery shopping after picking up their children from day care and after-school and spend weekends catching up on their yard work. Having paid off their mortgage, the Joneses earn the imputed rent on their home, while the Smiths pay this "rent" to the mortgage company but take a tax deduction. The Joneses estimate the value of their leisure time spent with their children at \$40,000 per year. The Smiths pay \$7,000 each year for pre-school and after-school programs so that they can enjoy the opportunity to work 40 hours per week. Only a poll tax could secure perfect horizontal equity if the Smiths and Joneses are thought of as equals. A real-world system of taxes with relatively narrow bases will yield less horizontal equity. At best we're left with the guideline that the narrower the base, the more opportunity for different treatment of so-called equals.

Except when presented with evidence that certain wealthy citizens and corporations paid no income tax, the general public rarely cries for more horizontal equity. This is not surprising; it is unlikely that equals can perceive unequal treatment, except in its extreme. For Smith to realize the inequity of the tax system, he would have to know who his equals are and how much they pay in taxes. There is substantial survey evidence that most taxpayers don't know how much they themselves pay in taxes.³⁸

In essence, horizontal equity and vertical equity are difficult to assess because for the former, it's hard to agree on the right question, and for the latter, it's hard to agree on the right answer.

The Trade-off between Vertical Equity and Efficiency. Enhancing equity requires a sacrifice in the tax system's ability to raise revenues without disturbing the economy. Suppose that a head tax of \$2,500 per person were placed on every

³⁸ *Income Inequality*, Joel Slemrod, ed. (Cambridge University Press, 1994) 309-334.

Kentuckian.³⁹ Efficiency would require that the tax did not affect the relative prices of goods and services. Here, the only decision to make would be whether to leave the state. But let's assume that is a costly option. In the absence of any means to avoid the tax, Kentuckians will not avoid the tax. They will pay out of existing cash flow, sell assets, borrow, avoid saving, reduce consumption, or some combination of the above, to pay the \$2,500. The tax alters no prices, and therefore does not affect people's decisions to spend or save, work more or less, rent or buy, or purchase a different set of goods. In essence, other than an income effect, the tax is benign, which adheres to a basic principle of tax policy. Efficient taxes don't steer economic decisions.

The reason we have so few of these taxes is that they fail miserably on vertical equity grounds. Effective tax rates would naturally be higher for poorer families than for richer ones. Large families would be burdened more than small ones. Single millionaires would pay less than single mothers at the poverty level. So governments build progressivity into their tax codes.

Tax codes generate progressivity in two ways: exemptions and rising marginal tax rates. By far, the most popular means of increasing vertical equity is through exemptions of some kind. The sales tax exempts grocery food, some utilities, and most prescription drugs in order to carve out typical expenditures that constitute a large portion of low-income households' spending. The property tax exempts part of the value of the homes of elderly citizens to alleviate burdens on their incomes. The income tax allows standard or itemized deductions and personal credits to account for common expenditures households make, and for those with low income, a credit against their tax bill, effectively exempting some income from tax.

While serving to promote progressivity, exemptions require, for a given size of government, higher tax rates. Thus, nonexempt income, purchases, and property exact a higher toll than otherwise. The tax on the incremental activity beyond the exempted amount bears a higher tax. For example, absent all exemptions, the sales tax could shoulder its revenue burden with approximately a 3 percent rate. With a 3 percent rate on more purchases, the tax is more efficient, alters fewer decisions on buying clothes, TVs, lathes, presses, or computers. Herein lies the trade-off of equity and efficiency. Fortunately, for equity's sake, these altered decisions are difficult to discern, for the alternative choice is not made, and therefore can't be counted.⁴⁰ If the high tax rate discourages Smith from buying more bicycles, the transaction never occurs, no receipt exists, and no neighbors ask about that shiny new bike.

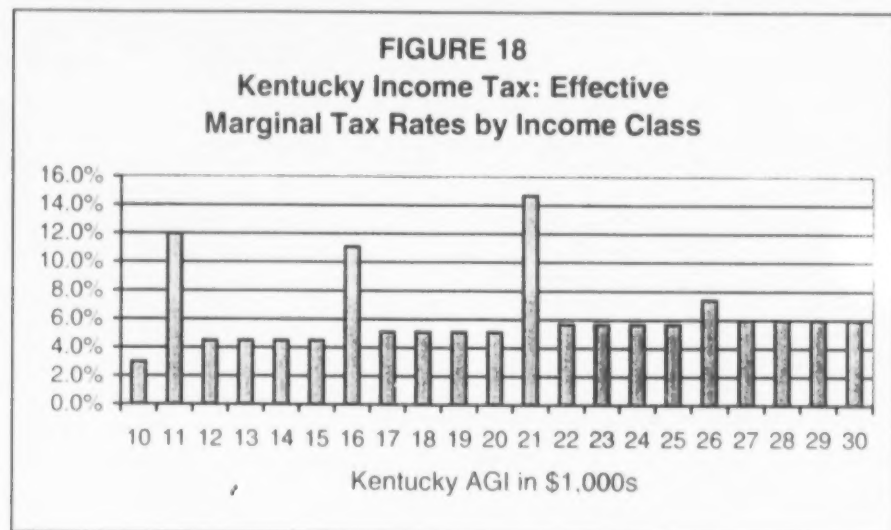
Traditional measures of incidence use effective tax rates by income class to assess the burdens on households at various points of the income distribution. If the question is "Who pays what, and is this a small or large portion of their ability to pay?" these calculations are appropriate. Judgments can then be made about relative burdens and policymakers can then decide whether these relative burdens are

³⁹ Per capita state and local taxes in Kentucky were \$2,464 in 1999. Source: Census, *State and Local Finances*.

⁴⁰ For a good presentation of the problem, see Frederic Bastiat, in *Selected Essays in Political Economy*, G.B. deHuszar, ed., Foundation for Economic Education, 2000, Chapter I.

appropriate. However, this is not enough, for it neglects the incremental effect of the tax code, which is an important part of any discussion of how government affects its constituents. Average burdens look at how much a household paid across all dollars they earned. This measure ignores the most relevant dollars to the taxpayer, i.e., the marginal dollars. If we ask the question "How does an increase in income of \$100 affect one's tax bill?" we get at how the government treats decisions to work, save, or invest, across different income classes.

Tax credits can also improve progressivity, but in doing so, raise marginal tax rates. Tax credits are sometimes preferred to straight exemptions because they can be targeted toward intended recipients. The low-income credit cuts the income tax by \$57 million per year, but only for those with incomes less than \$25,000. However, because the credit targets low-income households, the phase-out of the credit as income rises creates high marginal tax rates (see Figure 18). The credit forces the highest marginal tax rates on those helped by the credit. The following chart shows marginal tax rates by income level. Because of the low-income credit thresholds, an increase in income over that threshold can subject poor families to a marginal tax rate of greater than 14 percent. So, low-income families' decisions to earn extra income are taxed more than for any other households. A marginal rate of 14 percent on Kentucky's income tax means that the additional \$1,000 is worth only \$860. Subtract from this the marginal federal income tax, and the rate at which cash or in-kind transfers are reduced as earnings increase, and government has clearly reduced the incentive to work and invest in human capital.



Tax Equity Is Only Half the Story—Benefits Incidence Matters. Studies of tax incidence usually hint at the logical necessity of including the spending side of government when determining the overall burden of government. Of course, if the question is whether the government budget treats its citizens fairly, it makes sense to include every dollar of tax paid and benefits received by citizens. On net, how much better or worse off are citizens across income classes as a result of the current size and nature of government? Using the economist's definition of consumer

surplus, the difference between what people are willing to pay and what they actually pay would be most appropriate to ascertain how government treats its various citizens. While this is probably the question policy analysts have in mind when they think of equity, they are sadly disappointed by the inability to measure benefits received. The indivisibility of public goods, free-rider problems, and the lack of pricing of public services renders benefits incidence all but impossible. The next best strategy is to ask, "Given the current budget, how does the tax share differ across income classes?" This inquiry has more value the more society adheres to an ability-to-pay principle of taxation but still falls short.

CONCLUSIONS

A look at average tax rates by income class reveals a roughly proportional tax burden in Kentucky, with some regressivity at the high end. While Kentucky fails to provide real relief to families at the poverty level through its income tax, it does this largely out of inattention to the effect of inflation on tax burdens. In recent years, the legislature has enacted indexing provisions in the standard deduction and in the pension exclusion, but the impact on the working poor has been minimal. Sales and use tax exemptions carve out a portion of a working family's consumption spending, and property taxes have exacted a dwindling share of state and local taxes.

With regard to marginal tax rates, Kentucky fares a bit worse, charging the highest rates on working families near the low-income thresholds. And those working families not near the thresholds pay at marginal rates similar to those faced by Kentucky's highest income families. It would be hard to argue that it is fair for any tax system to discourage the poor from economic activity more than the rich. Had Kentucky's income tax system been indexed to maintain its original progressivity, the credit that creates these problems would have been unnecessary.

Still, reform necessary to significantly alter tax burdens among income classes carries a high cost. Because Kentucky has so many poor families and so few rich ones, redistribution that would really help working families near the poverty level would impose tax increases on the relatively few higher income families that would be politically burdensome for elected officials. It is hard to imagine a successful political strategy built around mildly helping the majority while significantly dunning the few. The existing process is the same one that created the generous menu of exemptions to do just the opposite.

Horizontal equity issues remain complex but present opportunities where sound tax reform can improve things. Kentucky's many exemptions and exclusions that riddle its large taxes create opportunities for unequal treatment of taxpayers that appear similar. While unequal treatment is hard to discern (for taxpayers as well as policy analysts), it is also hard to justify. At best, the argument for eliminating horizontal inequities hangs on efficiency. Expanding the base and lowering the rates of Kentucky's taxes is a win-win solution, mitigating equity effects while removing distortions caused by unnecessarily high tax rates.

The problem of the digital divide, or effect of new technology on the distribution of opportunities to evade taxes, is a symptom of a larger problem. Governments do best when first imposing rules on the populace over which they have jurisdiction. Optimizing these rules as circumstances change, creating innovative approaches, and instituting multijurisdictional solutions are far more problematic. For what it matters, the problem of use tax evasion attributable to Internet commerce may be more of a business tax rather than a personal tax issue. The resulting incidence of the noncompliance problem is such that the poor and the rich may be affected more or less equally.

In conclusion, it is not a stretch to claim that equitable tax systems are hard to come by and hard to maintain. Even the soundest of tax reform has to play off equity with other policy goals. A state such as Kentucky, long grappling with issues of investment in economic and social capital, may have had to forego a degree of equity to pursue growth and development. Furthermore, time, technology, and the economy are not always allies to well-intentioned legislation. At some point, the current tax structure in Kentucky will work against the goals of the Commonwealth; some may make the case that it already does.

5

BUSINESS TAXES IN KENTUCKY

By Lawrence K. Lynch

This paper discusses rationales for business taxation, summarizes the issue of business tax incidence, reviews earlier studies of Kentucky's relative business tax burden, and compares Kentucky's business tax burdens with those in neighboring states. One recent study found that Kentucky's business tax burden was average while another found it to be relatively high. This analysis finds Kentucky's business taxes comparable with those in neighboring states, but personal taxes are relatively high. Kentucky is a poor state that must levy relatively high taxes to provide an average level of public services, but the high tax burden is borne disproportionately by individual taxpayers, not businesses.

Is Kentucky's tax structure competitive, or do we discourage capital investment in Kentucky with high business taxes? Two recent studies of business tax burdens came to opposite conclusions: a Barents Group analysis found that Kentucky has average business tax burdens and higher-than-average individual tax burdens, but a joint study by the University of Kentucky Center for Business and Economic Research and the University of Louisville College of Business and Public Administration (UK-UL) found that Kentucky has above-average business tax burdens.⁴¹

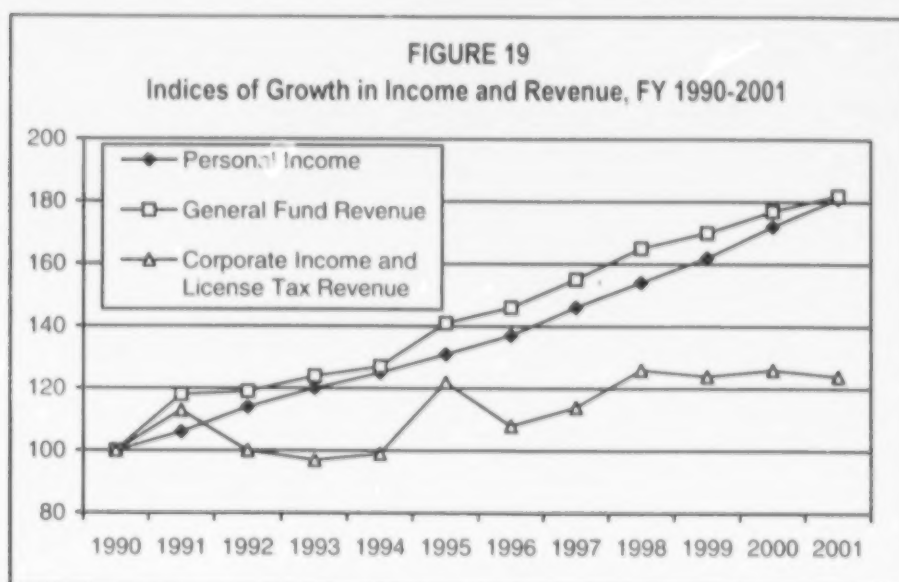


At first glance, it is difficult to see how anyone could argue that Kentucky overtaxes businesses. Figure 19 shows that, over the past decade, Kentucky's two major state business taxes—the corporation income and license taxes—have pro-

⁴¹ William H. Hoyt, Mark C. Berger, and Paul A. Coomes, *Statutory and Economic Incidence of Taxes in Kentucky and Surrounding States* (University of Kentucky, Center for Business and Economic Research & University of Louisville, College of Business and Public Administration, 2001).

duced revenue growth of just 20 percent. Meanwhile, total General Fund revenue growth matched total personal income growth of about 80 percent.

Figure 19, though, does not include every state tax that businesses pay, and omits local taxes altogether. And even if Kentucky's business tax burden has fallen over time, perhaps the burdens in other states have declined more. This chapter will revisit the issue of business taxes, beginning with a discussion of the kinds of business taxes, the reasons for business taxes, and the incidence of business taxes. Then we will review the Barents and UK-UL studies as well as some earlier research. Finally, we will provide new estimates of business tax burdens in Kentucky and surrounding states.



BUSINESS TAXATION

Taxes imposed on business by state and local governments include levies on the right to do business (e.g., franchise taxes), on the purchase of inputs (e.g., sales taxes, unemployment insurance taxes), on the ownership or transfer of assets (e.g., business property taxes, corporation license taxes), on net income (e.g., the corporation income tax), on the depletion of nonrenewable resources (e.g., severance taxes), and levies related to external costs thought to be imposed by businesses (e.g., excise taxes on the sale of liquor).⁴²

The justifications for business taxes include ability to pay, tax exporting, political expediency, and the benefits principle⁴³—the same justifications that support personal taxes. But business entities themselves do not bear the burden of

⁴² William H. Oakland and William A. Testa, "State-Local Business Taxation and the Benefits Principle," *Economic Perspectives* 20.1 (1995): 3.

⁴³ Oakland and Testa 4.

taxes. Although the initial impact of a business tax may be on the business entity, the ultimate burden (the *incidence*) depends upon the ability of the business to *shift* the tax—either to consumers via higher prices or to input suppliers via lower input costs. The owners of the business pay the portion of business taxes that cannot be shifted. Thus, every business tax is ultimately borne by individuals, partly as consumers paying higher prices and partly as owners of inputs (land, labor, or capital) receiving lower incomes.

Economic research has found the following:

- 1) sales and excise taxes are at least partly shifted to consumers through higher prices,⁴⁴
- 2) payroll taxes are shifted to employees through lower wages,⁴⁵ and
- 3) taxes on business capital—net income and property—are borne by the owners of capital.⁴⁶

SHOULD BUSINESS TAXES BE LIMITED TO THE COST OF SERVICES?

Oakland and Testa argue that "... general business taxation should be structured so as to recover the costs of public services rendered to the business community."⁴⁷ Individuals should bear the burden of taxes that pay for the services that benefit people, the argument continues. If business taxes are used to subsidize general public services, citizens will demand more services than they are willing to pay for, and the public sector will grow too large. Moreover, attempts to export taxes can be effective only in situations where a jurisdiction "... has some competitive advantage due to superior or unique natural resources,"⁴⁸ such as Kentucky coal or Florida beaches. Finally, high business taxes may lead to capital flight—reduced business investment in the state.

Business taxes that conform to the benefits principle would be efficient, Oakland and Testa believe, because the prices of goods and services produced in each state would reflect their full costs of production. In addition, benefits-based taxes would be neutral with respect to capital mobility.

Current levels of business taxation have been found to be higher than needed to offset the costs of public services. Oakland and Testa estimated that, for the nation in 1992, state and local business taxes were 71 percent higher than the public expenditures that benefited business.⁴⁹ An analysis for Kentucky found that business taxes in 1994 exceeded business public expenditures by 88 percent.⁵⁰

The argument that business taxes should be based solely on the benefit principle is not completely convincing. To the extent that owners of capital ultimately

⁴⁴ Harvey S. Rosen, *Public Finance*, 5th ed. (Boston, MA: Irwin McGraw-Hill, 1999) 262-3.

⁴⁵ Rosen 267.

⁴⁶ George R. Zodrow, "The Property Tax as a Capital Tax: A Room with Three Views," *National Tax Journal* 54.1 (2001): 139-156.

⁴⁷ Oakland and Testa 2.

⁴⁸ Oakland and Testa 5.

⁴⁹ Oakland and Testa 10.

⁵⁰ Robert W. Cox (Kentucky Cabinet for Finance and Administration), "Business Taxes and Tax Incentives: What's Going On Here?" unpublished article, Frankfort, 1996, 16.

pay business taxes, such taxes are progressive, and therefore arguably fairer. And poor states like Kentucky may well export much of the burden of business taxes. Kentucky's median household income is below the national average and our poverty rate is above average.⁵¹ And family net worth is much lower in the U.S. South than in the Northeast or Midwest.⁵² Thus, many stockholders in the multistate corporations that operate in Kentucky may well live in other states and yet indirectly pay Kentucky taxes.

CAPITAL MOBILITY

Stockholders, however, are unlikely to keep their capital in a place or in an industry where its after-tax return is low. Because capital is mobile, it will move to the location where it will earn the highest return. "If a tax on capital in a single state (or industry) reduces the after-tax rate of return, investors will move their capital to lower-tax locations (or industries)."⁵³ Thus, at equilibrium, the net after-tax rate of return on capital should be equal in all locations and all industries.

This would seem to imply that if a state were to reduce business taxes it would upset the existing equilibrium and attract business investment. But state and local taxes represent only a very small portion of business costs and, for this reason, may have little effect on business location.⁵⁴ Labor, energy, and transportation costs matter most.

Further, because business location decisions are at least influenced by managers who must move their residences to the selected location, *personal* state and local taxes may be equal in importance to business taxes. But why focus on taxes? Taxes are the costs of public services; if services are satisfactory, the tax costs will be accepted. Indeed, the states with the highest per capita incomes are also those with the highest taxes—and probably the highest quality public services.⁵⁵

STUDIES OF KENTUCKY'S BUSINESS TAX BURDEN

Many studies of state and local tax burdens define "burden" as tax revenue divided by some measure of taxpaying capacity—which may or may not be the actual tax base. The effects of tax shifting are often ignored in these studies. Over the past 20 years, at least four analyses of Kentucky's tax burdens—business,

⁵¹ U.S. Census Bureau, *Statistical Abstract of the United States: 2000*, Tables 742: 469 and 759: 477, 120th ed. (Washington, D.C.: U.S. Department of Commerce, 2000).

⁵² U.S. Census Bureau, *Statistical Abstract*, Table 764: 481.

⁵³ Tax Research Division, *1995 Minnesota Tax Incidence Study* (St. Paul, MN: Department of Revenue, 1995) 34.

⁵⁴ Mark Zandi and Wesley Basel, *The High Price of High Costs*, Regional Financial Associates Research Paper, West Chester, PA, Oct. 1994.

⁵⁵ U.S. Census Bureau, *Statistical Abstract*, Table 727: 460 (Washington: U.S. Department of Commerce, 2001); available at: <<http://www.census.gov/govs/estimate/9818ky.html>> and <[ftp://www.census.gov/govs/pub/outgoing/97REX1.xls](http://www.census.gov/govs/pub/outgoing/97REX1.xls)>.

household, or both—have been conducted. Here, we consider the findings—and the flaws—of these analyses.

THE WHEATON STUDY

A 1983 study estimated 1977 business tax burdens in each of the 48 continental states. The measure of business taxes combined revenue from corporate income taxes, unemployment insurance taxes, severance taxes, license taxes, and portions of property taxes, insurance premium taxes, utility gross receipts taxes, and stock transfer taxes. No attempt was made to estimate business shares of general sales taxes.⁵⁶ The study used an estimate of business income in each state as the measure of taxpaying capacity. The Wheaton study found that Kentucky ranked 43rd among the 48 contiguous states in business tax burden; only two of our neighboring states (Indiana and Missouri) ranked lower.⁵⁷

THE ACIR'S REPRESENTATIVE TAX SYSTEM (RTS)

The Advisory Commission on Intergovernmental Relations (ACIR), a bipartisan commission created by Congress in 1959, developed standard measures of state and local tax capacity and tax effort, and reported their findings annually until the early 1990s. As defined by the ACIR, a state's "tax capacity" measured the wealth of a state (i.e., its ability to generate tax revenue); "tax effort" measured the extent to which a state utilized its capacity (i.e., its willingness to levy state and local taxes).

The ACIR's Representative Tax System (RTS) began with the computation, for each state, of the tax base for each of 27 widely used taxes. For example, a state's tax base for the sales tax was retail sales in the state; the tax base for the corporation income tax was total corporate profits in the state.

Next, for each tax, the national average state and local tax rate was multiplied by each state's tax base. The result was a state's "tax capacity"—the amount of revenue the state would produce if it applied the national average rate to its own base. A tax capacity index was then computed by dividing a state's per capita tax capacity by the national average per capita capacity. A state with a sales tax capacity of 90, for example, had 90 percent of the national average retail sales per capita.

A state's "tax effort," for any tax, was the percentage of its tax capacity that it actually utilized: per capita tax revenue divided by per capita capacity. By aggregating each state's tax capacity and tax effort over all 27 taxes in the RTS, the ACIR computed overall state indices for tax capacity and tax effort.

In 1991, *just after Kentucky substantially increased taxes to support education reform*, Kentucky's total tax capacity index was 83 and its tax effort index was

⁵⁶ William C. Wheaton, "Interstate Differences in the Level of Business Taxation," *National Tax Journal* 36.1 (1983): 84-5.

⁵⁷ Wheaton 89.

100.⁵⁸ Only 12 states, however, had a tax effort index higher than 100, which led the Kentucky Economic Development Corporation (KEDC) to declare "... Kentucky's tax burden has increased to the point that we are at a competitive disadvantage with respect to economic development."⁵⁹

Although the ACIR did not allocate tax revenue into business and household categories, the KEDC found that Kentucky's tax efforts on corporation income and net worth taxes were well above average. Our personal income tax effort was even higher; however, our property tax effort was significantly below average, and our sales tax effort was slightly below average.⁶⁰ Since business taxes include portions of the property and sales taxes, where Kentucky's effort was below average, as well as the corporation income tax, where Kentucky's effort was high, the ACIR findings were inconclusive with respect to the business vs. household tax burdens.

The Wheaton study found that Kentucky had a low business tax burden in 1977; the ACIR found that Kentucky's overall tax effort, and perhaps our business tax effort, was high in 1991. We now turn to two recent studies of Kentucky's current business tax burdens, studies that come to very different conclusions.

THE BARENTS STUDY

This 1999 study estimated both business and household tax burdens. To determine business tax burdens, the Barents Group created hypothetical "representative firms" in 19 industries. Then they calculated revenue, costs, assets, and liabilities for each firm based upon national averages and located one firm from each industry in Kentucky and in each of 14 comparison states.⁶¹ The model then simulated a hypothetical \$100 million expansion investment for each firm and calculated the marginal effective tax rate (the difference between the pre-tax and after-tax rates of return) for each industry in each state.

Pre-tax revenue and costs were based upon "... the actual experience of firms of a certain size in each industry covered by the study." Data were obtained from the Internal Revenue Service's *Corporation Source Book*.⁶²

The business taxes examined in the study were the corporation income tax, the corporate franchise tax, the property tax, and the sales and use tax on business purchases.⁶³ Business taxes were reduced by generally available tax credits, but not by credits redeemable only under specialized conditions. In Kentucky, credits under the Kentucky Industrial Development Act (KIDA) and the Kentucky Jobs Development Act (KJDA) qualified, but credits under two other programs did

⁵⁸ Advisory Commission on Intergovernmental Relations, *RTS 1991 State Revenue Capacity and Effort*, Report M-187, Washington, D.C., Sept. 1993, as reported in KY Economic Development Corp., *Kentucky's Tax Competitiveness* (Lexington, KY: Author, 1993).

⁵⁹ KY Economic Development Corp. 15.

⁶⁰ KY Economic Development Corp. 18.

⁶¹ The seven contiguous states plus all southeastern states except Florida and Louisiana, plus Michigan.

⁶² KY Economic Development Corp. 41.

⁶³ Barents Group, LLC, *Comparative Analysis of Kentucky's Tax Structure* (Washington, D.C.: Author, 1999) 40.

not.⁶⁴ Because there is considerable variation in local property tax rates, the representative firms were placed in cities that had property tax rates close to the state-wide average.

"Generally, Kentucky's state and local tax system performed in the middle of the comparison states in terms of overall business tax competitiveness across all of the study industries."⁶⁵ Property and sales taxes are relatively low in Kentucky, low enough to offset a relatively high corporation income tax.

Household Tax Burdens. Barents compared household tax burdens by creating ten hypothetical households of different sizes and income levels, and placing them in Kentucky and each of the 14 comparison states. The state and local taxes calculated for each household were personal income taxes; property taxes; general sales taxes; gross receipts on utility usage; and excise taxes on motor fuel, alcoholic beverages, and tobacco product consumption.⁶⁶ (Household expenditure patterns were derived from the Census Bureau's *Survey of Consumer Expenditures*.)

Kentucky households ranked relatively high in household tax burdens (3rd or 4th highest for all households except the two poverty-level examples, which ranked 6th and 7th). Kentucky's substantial state and local income taxes were the main reasons for our high household tax burden.⁶⁷

Critique. The main criticism of the Barents study is that everything except taxes was held constant. All other costs—labor, energy, transportation—were assumed to be equal for each industry in each state. The purpose, of course, was to isolate the effects of state and local taxes. But other cost differences could, in principle, offset differences in taxation. For example, suppose the \$100 million investment in Trucking and Warehousing (the highest-tax industry) produced pre-tax income of \$10 million. The difference between effective combined tax rates in the lowest-tax state and the highest-tax state was 15.19 percent, or about \$1.5 million.⁶⁸ It is quite possible that savings in labor, land, or transportation costs in the high-tax state could exceed \$1.5 million.

A second criticism of the Barents study is that it did not consider differences in public services to either businesses or households. If one state offers better education or better highways, businesses and households might be willing to accept a higher tax burden.

A third criticism is that taxes were calculated in a straightforward way without taking advantage of various tax avoidance techniques such as using nongeneral tax incentive programs, creating subsidiaries specifically to take advantage of certain tax exemptions,⁶⁹ or shifting profits to other states via sophisticated transfer pricing.

⁶⁴ Barents 17.

⁶⁵ Barents 46.

⁶⁶ Barents 68.

⁶⁷ Barents 69-80.

⁶⁸ Barents, Table 4-5, 50.

⁶⁹ For example, Kentucky law allows manufacturers to exempt from the use tax any energy costs in excess of 3 percent of their total cost of production. Some manufacturers reduce their total cost of

While thoughtfully conceived and carefully executed, the Barents study findings, nevertheless, should be taken only as a guide to the business and household tax burden rankings of the comparison states.

THE UK-UL STUDY

The University of Kentucky Center for Business and Economic Research and University of Louisville College of Business and Public Administration study divided tax revenue into business and personal categories, then summed the business tax revenue and divided both business taxes and total taxes by an aggregate measure of taxpaying capacity to calculate an "effective tax rate." The study examined state taxes and combined state and local taxes in Kentucky and the seven states that border Kentucky.

The taxes allocated to business included the following: the corporation income tax, business license taxes, severance taxes, public utility taxes, the business share of property taxes, unemployment insurance taxes, and workers' compensation costs.⁷⁰ No portion of sales taxes was allocated to business. (Recall that the Barents study calculated sales and use taxes on business purchases of intermediate goods but did not include public utilities taxes, the unemployment insurance tax, or workers' compensation costs.)

The UK-UL study found that Kentucky's *state* business tax burden was 65.2 percent higher than the unweighted average for all eight states.⁷¹ Kentucky's combined *state and local* business tax burden was 8.4 percent above the eight-state average. Kentucky's total state and local tax burden—business and household—was 15.1 percent above the eight-state average, implying that our households are burdened even more than our businesses.

Critique. The main reason that Kentucky's business tax burden appeared to be so high in the UK-UL study was the peculiar choice of tax base. Most studies that select a single broad measure of taxpaying capacity as the tax base use total personal income. UK-UL used *private earnings*. Private earnings consist of wages and salaries, employee benefits, and proprietors' income. Total personal income includes *property income* (dividends, interest, and rent) and *transfer payments* (such as Social Security benefits) as well.

Table 9 reveals that Kentucky's ratio of private earnings to total personal income is lower than in five of the seven contiguous states. Thus, using private earnings as the tax base inflates Kentucky's tax-burden ranking. And it turned the Barents study on its head: Barents used pre-tax *profits* as its tax base; UK-UL did not even include profits in its tax base.

production—and thus increase the share of energy costs—by not taking possession of raw materials. Instead, they create subsidiaries which then contract with the parent manufacturer to process raw materials into finished goods. This device reduced Kentucky sales and use tax revenue by an estimated \$37 million per year in FY 2001 and 2002. See Robert W. Cox, "Sales and Use Tax Revenue Receipts," memorandum to Dr. James R. Ramsey, State Budget Director, Governor's Office for Economic Analysis, 18 May 2000, Frankfort.

⁷⁰ Hoyt iii.

⁷¹ Hoyt 5.

TABLE 9
Selected Economic Data for Kentucky
and Neighboring States, 1998

	State Share of State and Local Tax Revenue	Private Earning as Percent of Personal Income	Private GSP as Percent of Gross State Product
Kentucky	76.1%	55.4%	86.6%
Illinois	55.5	62.6	90.2
Indiana	62.1	61.3	90.2
Missouri	61.7	60.3	88.9
Ohio	57.2	59.8	89.2
Tennessee	62.0	63.2	88.5
Virginia	58.0	54.1	82.3
West Virginia	76.2	48.8	85.2

Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis.

Private Gross State Product (GSP) would have been a better tax base, both conceptually and in fairness to Kentucky. Private GSP is a good measure of business taxpaying capacity, since it is by definition the sum of all value added by businesses (total sales minus purchases from other businesses). Table 9 shows that the ratios of private GSP to total GSP are higher and more uniform than the ratios of private earnings to total personal income.

A second criticism of the UK-UL study is that it reported the burden of state taxes separately. Kentucky raises a higher portion of tax revenue at the state level than any of the comparison states except West Virginia, as also shown in Table 9. Thus, any comparison that omits local taxes is deceptive and unfairly disadvantages Kentucky.

UK-UL's failure to include the business portion of sales and use taxes may also be faulted. Several of the comparison states allow localities to impose sales taxes while Kentucky does not. And UK-UL included the unemployment insurance (UI) tax and workers compensation (WC) costs, which can be questioned. Most economists believe that the UI tax is shifted backward to employees.⁷² WC costs depend upon industry and firm risk factors that are independent of geographic location.⁷³

Like the Barents analysis, the UK-UL study can also be criticized for ignoring differences in labor, energy, and transportation costs and for not examining the quantity and quality of public services.

On balance, the UK-UL study gives a misleading picture of Kentucky's relative business tax burden. The next section presents several alternative new calculations of business tax burdens in Kentucky and surrounding states.

⁷² Harvey S. Rosen, *Public Finance*, 5th ed. (Boston: Irwin McGraw-Hill, 1999) 267.

⁷³ Daniel Mont, John F. Burton, Jr., Virginia Reno, and Cecili Thompson, *Workers' Compensation: Benefits, Coverage, and Costs, 1999 New Estimates and 1996-98 Revisions* (Washington: National Academy of Social Insurance, 2001) 22.

ANOTHER LOOK AT KENTUCKY'S BUSINESS TAX BURDEN

Data on state and local tax revenue in 1998 were obtained for Kentucky and contiguous states from the U.S. Bureau of the Census. The National Academy of Social Insurance⁷⁴ provided workers' compensation data. Tax revenue was allocated into business and household shares and then divided by each of four broad tax bases: total personal income, private earnings, gross state product (GSP), and private GSP, all of which were obtained from the U.S. Bureau of Economic Analysis (BEA).⁷⁵

BUSINESS TAXES AND TAX BASES

Two measures of business taxation were calculated: general business taxes and comprehensive business taxes. General business taxes included 100 percent of corporation income, corporation license, and other business license taxes, plus portions of property, sales, and insurance premium taxes.⁷⁶ Comprehensive business taxes added *pari-mutuel*, severance, and unemployment insurance taxes, and workers' compensation benefits.⁷⁷ Our measure of general business taxes was close to the definition used in the Barents study; our measure of comprehensive business taxes approximates the measure used in the UK-UL study.

Neither measure of business taxes included personal income taxes paid by unincorporated businesses (proprietorships, partnerships, or farms). This omission is common to business tax studies, primarily because of the difficulty of developing estimates of taxes paid. However, at the national level, the total earnings of unincorporated businesses, *proprietors' income*, was less than 5 percent of corporate profits in 1998.⁷⁸ This implies that corporations account for an overwhelming percentage of economic output.

Total personal income and GSP are broad measures of economic activity that reflect total taxpaying capacity. Private earnings omit all property income and are therefore a peculiar measure of *business* taxpaying capacity. Private GSP is a better business tax base because it is a measure of production in the private sector.

BUSINESS TAX BURDENS

Table 10 illustrates general business tax burdens: general business taxes divided by each of the four tax bases. As expected, Kentucky's relative burden was highest when divided by private earnings: 107.0 percent of the eight-state average. Our rank was third highest among the eight states. When measured against total per-

⁷⁴ Mont.

⁷⁵ Newman, Jeffrey L., "State Personal Income, Revised Estimates for 1997-99," *Survey of Current Business* 80.10 (2000): 63-67.

⁷⁶ The methods used to estimate business shares of tax revenue are discussed in the chapter Appendix on page 72.

⁷⁷ Because workers' compensation premium costs were not available, benefits paid was the measure used, as suggested by the National Academy of Social Insurance (see Mont 22.)

⁷⁸ Richard M. Beemiller and Clifford H. Woodruff III, "Gross State Product by Industry, 1997-98," *Survey of Current Business* 80.10 (2000): 69-90 and Appendix B, 80.

sonal income, Kentucky's relative business tax burden fell to 101.6 percent of average, and our rank fell to fourth. Measured against either GSP or private GSP, Kentucky's relative tax burden was slightly below average, and our rank was fifth.

TABLE 10
General Business Taxes per \$100 of Selected Tax Bases,
Kentucky and Surrounding States, 1998

	Total Personal Income	Private Earnings	Gross State Product	Private GSP
Kentucky	\$2.57	\$4.63	\$2.11	\$2.43
Illinois	2.70	4.32	2.30	2.55
Indiana	3.06	4.99	2.60	2.89
Missouri	2.38	3.94	2.02	2.27
Ohio	2.54	4.24	2.19	2.45
Tennessee	3.06	4.85	2.57	2.90
Virginia	1.95	3.61	1.63	1.98
West Virginia	1.97	4.03	1.80	2.12
Means	2.53	4.33	2.15	2.45
KY % of Means	101.6%	107%	98%	99.2%
KY Rank	4	3	5	5

Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis

Figure 20 charts the business tax burdens of each state relative to private GSP in rank order. The state with the lowest burden, Virginia, pays \$1.98 in business taxes for each \$100 of private GSP; Tennessee has the highest burden at \$2.90 per \$100.

FIGURE 20
**General Business Taxes per \$100 of Private Gross
State Product, Kentucky and Surrounding States, 1998**

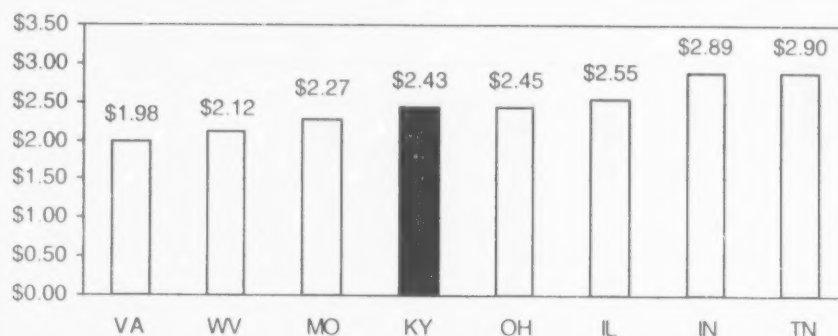


Table 11 compares comprehensive business tax burdens in the eight states, again dividing business taxes by each of the four tax bases. Kentucky's relative

burdens were slightly higher on the comprehensive business tax measures. Kentucky had the second highest relative burden, 108.0 percent of the eight-state average, when private earnings were used as the tax base. West Virginia's relative burden was 156.5 percent of the average, the highest of these states.

TABLE 11
Comprehensive Business Taxes per \$100 of Selected
Tax Bases, Kentucky and Surrounding States, 1998

	Total Personal Income	Private Earnings	Gross State Product	Private GSP
Kentucky	\$3.60	\$6.50	\$2.96	\$3.42
Illinois	3.52	5.63	3.00	3.32
Indiana	3.60	5.88	3.07	3.40
Missouri	3.06	5.07	2.60	2.92
Ohio	3.52	5.88	3.03	3.40
Tennessee	3.70	5.85	3.10	3.50
Virginia	2.38	4.40	1.98	2.41
West Virginia	4.59	9.42	4.21	4.94
Means	3.48	6.02	3.00	3.41
KY % of Means	103.4%	108%	98.7%	100.2%
KY Rank	3	2	6	3

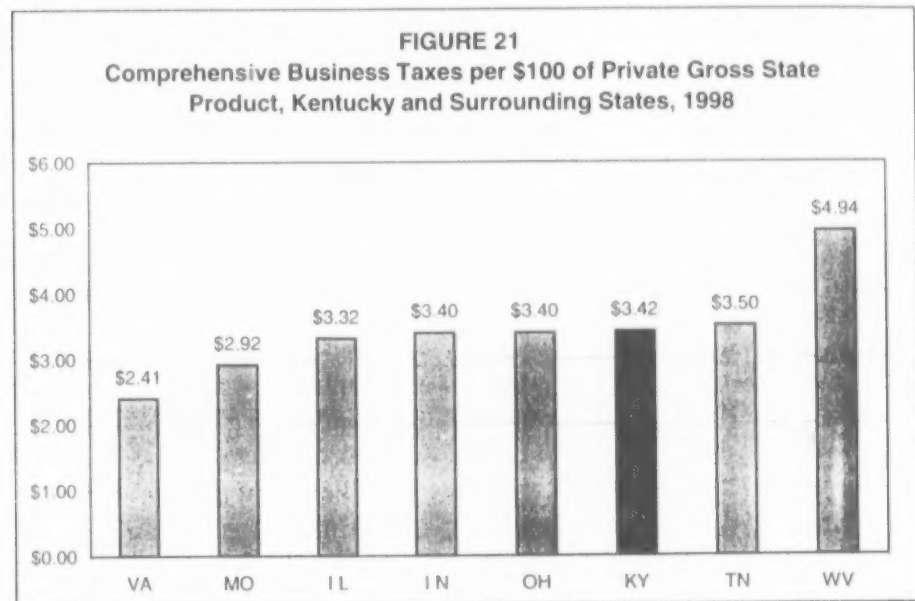
Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis

When assessed against total personal income, Kentucky's comprehensive business tax burden was 103.4 percent of average, and our rank fell to third. Measured against GSP, Kentucky ranked sixth, with a below-average relative tax burden. When computed against private GSP, Kentucky ranked third, and our relative tax burden was about average.

Kentucky's weaker performance on the comprehensive measure of business taxes is largely attributable to the coal industry. Kentucky and West Virginia are the only two states that have significant severance tax revenue. And since injury and illness rates are high in the mining industry, mining states tend to have high workers' compensation benefits. Kentucky's percentage of comprehensive business tax revenue from severance taxes and workers' compensation benefits exceeds the percentages in all but two comparison states (Ohio and West Virginia).

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Figure 21 charts the comprehensive business tax burdens of each state relative to private GSP, in rank order. The state with the lowest burden was again Virginia, which paid \$2.41 in comprehensive business taxes for each \$100 of private GSP. West Virginia had by far the highest burden at \$4.94 per \$100; nearly half of West Virginia's comprehensive tax revenue was produced by severance taxes and workers' compensation benefits.



PERSONAL TAX BURDENS

Kentucky's relative personal tax burdens exceed our business tax burdens. Table 12 compares personal tax burdens in the eight states, again dividing taxes by each of the four tax bases. (Personal taxes were computed by deducting comprehensive business taxes from total taxes.) Kentucky again had the highest relative burden, 113.6 percent of the eight-state average when private earnings were used as the tax base. Kentucky had the second highest personal tax burden on private earnings.

TABLE 12
Personal Taxes per \$100 of Selected Tax Bases,
Kentucky and Surrounding States, 1998

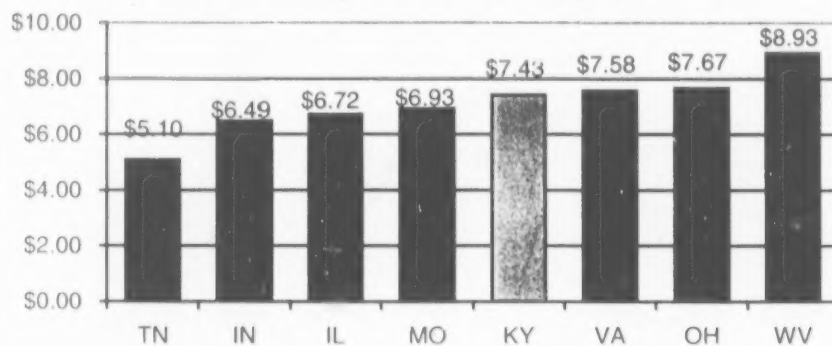
	Total Personal Income	Private Earnings	Gross State Product	Private GSP
Kentucky	\$7.84	\$14.15	\$6.43	\$7.43
Illinois	7.13	11.39	6.06	6.72
Indiana	6.87	11.20	5.85	6.49
Missouri	7.25	12.02	6.16	6.93
Ohio	7.93	13.26	6.84	7.67
Tennessee	5.39	8.52	4.51	5.10
Virginia	7.48	13.83	6.24	7.58
West Virginia	8.30	17.01	7.61	8.93
Means	7.19	12.46	6.18	7.06
KY % of Means	109.0%	113.6%	104.0%	105.2%
KY Rank	3	2	3	4

Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis

Kentucky's personal tax burden fell to 109.0 percent of the average when total personal income was the measure of taxpaying capacity; our rank was third. Measured against GSP, Kentucky again ranked third and our burden was 4.0 percent above average. With private GSP as the tax base, Kentucky ranked fourth with a burden equal to 105.2 percent of average.

Figure 22 illustrates the personal tax burdens of each state relative to private GSP, in rank order. The state with the lowest burden was Tennessee, which paid \$5.10 in personal taxes for each \$100 of private GSP. The state with the highest burden was West Virginia, at \$8.93 per \$100.

FIGURE 22
Personal Taxes per \$100 of Private Gross State
Product, Kentucky and Surrounding States, 1998



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KENTUCKY'S TAX INCENTIVES

The business tax revenue measures used in this report have already been adjusted for economic development incentives that reduce business taxes. But revenue has not been adjusted for *nonbusiness* tax subsidies that Kentucky (and perhaps other states) grant to businesses. Four Kentucky programs⁷⁹ allow firms that invest in Kentucky to keep a portion (from 2 percent to 6 percent) of their employees' *individual income tax* withholding as a "credit."⁸⁰ In Fiscal Year (FY) 2001, \$35.4 million in state wage assessment credits are expected to be claimed.⁸¹ Moreover, many local governments allow the firms that receive state incentives to keep a portion of *local payroll taxes* as well. The dollar value of credits claimed at the local level is unknown.

Another state incentive program, the Kentucky Tourism Development Act, enacted in 1996 and since expanded, allows tourism businesses to take a refundable credit against the state *sales tax*. The revenue loss attributable to this program is projected to be \$1.8 million in FY 2002.⁸²

The tax credits that businesses are allowed to claim against personal taxes distort the measurement of business tax burdens and increase the difficulty of forecasting personal tax revenue. It would be more transparent if Kentucky treated these nonbusiness tax incentives as expenditures and simply wrote checks.

CONCLUSIONS

Kentucky's general business tax burden, measured against private GSP, is average compared to our surrounding states. A comprehensive measure of business taxes found that Kentucky's burden is slightly above average, primarily because Kentucky levies severance taxes and incurs high workers' compensation benefits. Both of these factors relate to Kentucky's coal mining industry.

Kentucky's personal tax burden, on the other hand, has been found to be well above average in this study and in earlier studies by the ACIR, Barents, and even UK-UL. Kentucky is a poor state that must levy relatively high taxes to provide an average level of public services. But the high tax burden is borne disproportionately by individual taxpayers, not businesses.

⁷⁹ The four are: Kentucky Rural Economic Development Authority (KREDA), Kentucky Industrial Development Authority (KIDA), Kentucky Industrial Revitalization Authority (KIRA), and Kentucky Jobs Development Authority (KJDA). Recall that credits allowed by the KIDA and KJDA programs were included in the Barents study.

⁸⁰ Office of Financial Management and Economic Analysis, KY Finance and Administration Cabinet, "The Fiscal Impact of Economic Development Tax Incentives," *Kentucky Quarterly Economic & Revenue Report, Fourth Quarter Report, Fiscal Year 1999*, annual ed., Frankfort, 1999.

⁸¹ Office of Financial Management and Economic Analysis 25.

⁸² Finance and Administration Cabinet, Commonwealth of Kentucky, "Tax Expenditure Analysis, Fiscal Years 2000-2002," Frankfort, KY, Oct. 1999, 105.

APPENDIX

ALLOCATION METHODS

The methods used to divide property, sales, and insurance premium tax revenue into business and household shares were as follows:

- **Property.** Several states reported data on both assessments and revenue by type of property (Kentucky, Ohio, and Virginia). In each case revenue shares attributable to business were very close to business shares of assessed values. Illinois provided data on revenue, and Tennessee provided data only on assessments. I was unable to obtain any data from Indiana, Missouri, or West Virginia. However, there was remarkable consistency in the data that were available: about 50 percent of state government property taxes and 40 percent of local government were paid by businesses.
- **General Sales.** Estimated business shares of general sales taxes were obtained from a *National Tax Journal* article.⁸³ Kentucky's business share of 46 percent exceeded shares in all comparison states except Indiana, which also had a 46 percent business share.
- **Insurance Premiums.** National data on business and individual shares of insurance premiums for life, health, and property/casualty insurance were obtained from *The Statistical Abstract of the United States*. State data on life insurance shares were obtained from the *Life Insurance Fact Book*.⁸⁴ State data on health and property/casualty insurance could not be found. However, life insurance shares were nearly the same in all states. Therefore, the average nationwide share of all insurance premiums paid by businesses, 47.5 percent, was applied to each state's insurance premium revenue.

⁸³ Raymond J. Ring Jr., "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal* 52:1 (1999): 79-90.

⁸⁴ American Council of Life Insurance, *Life Insurance Fact Book, 2000* (Washington: Author, 2000).

6

LOCAL GOVERNMENT FINANCES IN KENTUCKY

By David E. Wildasin

Local governments are an important part of any complete picture of government finance in Kentucky. They raise significant amounts of revenue, and, especially in the area of education funding, are the recipients of substantial transfers from the state government. The types of taxes that localities can use, and the amount of revenue that they can obtain from these taxes, are regulated by the state government. The result is a complex system of intergovernmental fiscal relations. The equity and efficiency implications of the existing system, considered as a whole, are quite uncertain. Potential reforms of local government finance raise important issues about the value of local fiscal autonomy and related questions of efficiency and equity in taxation and overall public-sector performance.

INTRODUCTION

Local governments in Kentucky—counties, cities, school districts, and special districts—raise a significant amount of revenue using a variety of tax instruments, including but not limited to local property taxes. Their tax systems are regulated in important ways by the state government, and they are also the recipients of substantial transfers from the state government. Basic data about the role of local governments in the overall fiscal system of the state are presented in Chapter 2. The present chapter focuses on a number of more specific aspects of local government finance in Kentucky. The first section is devoted to a discussion of the economic effects of local property taxes and to the potential impact of House Bill 44 (HB 44), a major property-tax limitation statute passed in 1979. This chapter also reviews the use of local “income” taxes (more properly, local occupational license taxes) in Kentucky. The third section focuses on the financing of local school districts, paying particular attention to limitations on the types of tax instruments available to these governments and also to the system of fiscal transfers through which the



state government supports local school district expenditures. The remainder of this chapter is devoted to a preliminary discussion of the issue of local fiscal autonomy and state restrictions on the powers of local governments to choose their own fiscal policies.

STATE REGULATION OF LOCAL FISCAL POLICIES: PROS AND CONS

Local governments in Kentucky are constrained both in the *types* of taxes that they can use and in the tax *rates* that they are permitted to apply. In some instances, localities are required to impose taxes no lower than a specified amount (for example, school districts cannot reduce property taxes below a certain rate); in other instances, there are maximum tax rates (for example, the occupational license tax rate for a county government generally cannot exceed 1 percent); and in still other instances, tax rates can be adjusted but only in ways that are compatible with limits on annual growth in revenues (most local property tax rates must be adjusted so that revenues grow no more than 4 percent annually); higher increases are possible, but may be subject to special voter approval. In the case of local school districts, not only taxes but expenditures are limited: school spending cannot fall below certain levels, nor can it exceed certain levels. This system of fiscal regulation has created a very complex structure of local taxation in Kentucky, many (if not all) details of which are reviewed in the following sections. But before delving into these complexities, it is appropriate to review some basic principles that can guide our thinking about state regulation of local government fiscal policy.

Local Policy Autonomy and Economic Efficiency. At least from the viewpoint of economic analysis, the main rationale for regulation of the fiscal policies of lower-level governments by higher-level governments is that the latter, if unregulated, may choose policies that are in some way detrimental to the broader interests represented by the former. A good example of this appears in the commerce clause (Art. 1, Sec. 8) of the U.S. Constitution, which prevents state governments from erecting barriers to free interstate commerce, such as tariffs on imports from other states. The commerce clause limits the menu of policy options for each state in ways that might be seen as harmful when viewed from the perspective of a single state, but it preserves a free internal market for the U.S. economy as a whole, with great economic benefits for the residents of all states. Acting unilaterally, individual states might find it advantageous to introduce impediments to interstate trade but they would neglect the economic harm that this causes for other states. Each in the end would be harmed by the policies of the others, and restrictions on the freedom of individual states can ultimately make all better off. Similarly, state government regulation of local policies may improve overall economic performance for the residents of the state, especially when localities are thereby prevented from pursuing policies that are harmful to residents of other localities. The economic term "externality" is often used to describe situations where the actions of one decisionmaker (a consumer, a firm, or a government,

depending on the context) affect the economic well-being of others in the society without their explicit agreement.⁸⁵

On the other hand, one of the chief economic benefits of a federal structure of government is that it allows lower-level governments to exercise autonomy in significant spheres of policymaking so that policies can be adjusted in accordance with the priorities, interests, and varying conditions found in different jurisdictions. The state of Kentucky has wide latitude in choosing its fiscal policies and is not required to mimic exactly the policies of New York, California, or Alaska, or to follow the directives of the U.S. Congress or of a Washington bureaucracy. Instead, state government officials attempt to adapt state tax policy, expenditure priorities, and other public policies to the political constituencies that matter most to them—voters in their districts, representatives of important commercial interests, and the like. Kentucky's economic policies reflect a gradual and ongoing process of adaptation to changing economic, demographic, and other important conditions within the state. By the same logic, the policies of local governments can reflect the varying circumstances of individual localities within the state. The residents of one locality may place a high priority on improvements to roads, others may consider public safety a critical need, and still others might emphasize the need for better water and sewerage systems. Local governments thus provide a political framework within which local priorities can be articulated so that scarce tax revenues can be directed to their highest-value uses. In this way, local fiscal autonomy can promote more efficient resource allocation than would be achievable by having all policies controlled by a higher-level government.

A lack of uniformity in policymaking is thus a hallmark of a federal system of government. Each state and local government is likely to choose policies that differ somewhat from those of other states and localities. Precisely because of the economic, social, and demographic diversity of states and localities, it is usually economically inefficient—that is, wasteful of scarce resources—for all policies, including tax policies, to be applied uniformly to them. But not all of the manifestations of economic and other diversity are necessarily welcome. The residents of a poor state or a poor locality may not willingly tax themselves at a rate sufficiently high to finance the same level of provision of public goods and services as the residents of a rich state or locality. This is as true of states and localities at different points in time as it is for states and localities at any one moment in time. To take a historical illustration, Kentuckians today are far richer than they were a half century or a century ago, and levels of public services that would have been regarded as extravagant in earlier times are taken for granted today. Kentuckians could have attempted, in 1901, to establish a road system of a size and quality that

⁸⁵ When a manager directs a worker to stay on the job from 8:00 until 5:00, or a consumer walks out of a bakery with a loaf of bread, the manager or consumer affects the well-being of the worker or of the bakery-owner. But these are not "externalities" because the manager must obtain the consent of the worker by offering adequate remuneration and the consumer must obtain the consent of the bakery-owner by paying the stated price for a loaf of bread. Externalities are so called because they are "external" to normal contractual relationships. Building a noxious facility without the consent of neighboring landowners is one example of an externality; the decision by one county to operate a landfill in a location that pollutes the groundwater of a neighboring county, without compensating it or otherwise obtaining its consent, is another.

approximates that of 2001, but to do so would have wasted scarce resources that were instead put to higher-priority uses, both private and public. Similarly, in present-day Kentucky, some regions and localities are more affluent than others. Residents in some localities might resist paying taxes for levels of public services that seem well worthwhile to taxpayers in other localities. Inequality in local public-service provision is an expected consequence of underlying economic inequality.

Local Policy Autonomy and Equity. Inequality, which is a mathematical concept, is not necessarily the same thing as inequity, which is an ethical concept. Any particular form of inequality may or may not be an inequity, and some types of equality might be viewed as inequities. Without prejudging the ethical issue, it is clear that a number of state government regulations and other policies are designed (whether effectively or not) to bring about greater uniformity of public service provision. This issue is discussed further below in the context of primary and secondary education.

One can see from the foregoing remarks that the basic issues of equity and efficiency arise in state-local fiscal relations and regulatory policies. If the residents of a particular locality value a public service and are willing to pay for it in the form of higher taxes, there is a reasonable presumption that they should be allowed to do so on economic efficiency grounds. From the viewpoint of the "benefit" principle of taxation, such local taxes and spending seem fair: local residents are exchanging their tax dollars for valued public services. However, if local policies harm or benefit other localities, state intervention may be justified on efficiency grounds either to discourage or encourage the local activities that produce adverse or favorable effects on others. Efficient resource allocation may, however, come into conflict with equity goals because efficient provision of public services by local governments typically results in variation in public service levels as a consequence of varying local demands and costs. Intervention by the state government may help to limit the scope of local variations, which, while it can conflict with efficiency, may promote equity.

In summary, as a guideline for thinking about the issue of local fiscal autonomy, it is helpful to bear in mind the key questions:

1. Does any particular local policy affect residents in other localities, either favorably or unfavorably?
2. Does local autonomy produce outcomes that violate ethical norms, and if so, how?

Local expenditure and revenue autonomy has substantial potential economic benefits which are worth preserving, but sometimes it may be better to curtail local autonomy in order to enhance the efficiency of resource allocation or to promote important equity objectives. These principles can provide policy guidelines to ensure that regulations imposed on local governments, where warranted, are targeted as effectively as possible and impose the least cost.

LOCAL PROPERTY AND INCOME TAXATION IN KENTUCKY

As noted in Chapter 2, local governments in Kentucky, including school districts, rely much less heavily on property taxes as a source of revenues than do most local governments in the United States. Does this mean that local governments are somehow unduly constrained in their ability to raise revenues, or does it simply reflect a policy shift away from reliance on the local property tax? Recall from Chapter 2 that local governments in Kentucky obtain a comparatively large share of their revenues from "income" taxes. In the very important area of primary and secondary education, a comparatively large fraction of the revenues of local school districts derives from transfers from the state government.

Whether deliberate or not, Kentucky's de-emphasis of the property tax raises several questions for public policy. How does a shift toward income taxes and away from property taxes affect the economic incidence of taxes in Kentucky? How does such a shift affect economic incentives, recognizing that both forms of taxation may change the rewards for various forms of economic behavior? Does the current mix of taxes provide local governments with a high degree of fiscal autonomy, enabling them to respond effectively to varying local demands?

This section examines the main revenue instruments used by local governments in Kentucky, focusing particularly on the finances of municipal and county governments and leaving school districts aside for later analysis. After reviewing some of the important economic aspects of local property taxation, the focus shifts to state policies that have governed local use of the property tax. Finally, local taxes on income are discussed, again focusing on state regulation of local taxing powers and the issue of local fiscal autonomy.

EFFICIENCY AND EQUITY EFFECTS OF LOCAL PROPERTY TAXES

The economic effects of local property taxes has been the subject of considerable study. To a first approximation, economists view the local property tax mainly as a tax on the return to investment in real property, including both residential and nonresidential real property. If investment in property is expected to yield a return of, say, 10 percent annually, then a property tax rate equal to 1 percent of the value of the property lowers the net return on the investment from 10 percent to 9 percent; similarly, a 3 percent tax would reduce the net return to 7 percent. These taxes would, respectively, be equivalent in their effects to taxes on the return to investment of 10 percent or 30 percent. As such, the property tax can be expected to reduce the level of investment in a locality or, when applied by many localities, in the state as a whole. These effects can produce significant efficiency costs, in many ways not dissimilar to those resulting from an income tax.

It should be noted, however, that the local property tax not only discourages investment in particular jurisdictions. It also tends to reduce the number of residents and the volume of commercial and industrial activity, for instance by shrinking the housing stock (since property taxes raise the cost of housing) and by limiting the number and size of firms located within a given jurisdiction. While this might appear to be an adverse impact of the tax, it partly serves a useful re-

source-allocation function. When more people reside in a locality, the cost of providing public services (police and fire protection, education, and many others) to a now-larger population will rise. The presence of these households thus imposes a cost on the locality. The same is true for businesses, whose presence again necessitates the expenditure of additional public-sector resources in order to meet their demands for local public services. From the viewpoint of economic efficiency, these households and businesses should locate in a given jurisdiction if the economic benefit of doing so exceeds the cost, and this cost includes the burden that they impose on local government. In order for them to face the proper incentives in making locational decisions, it is desirable for them to bear taxes, in each locality, equal to the cost of providing additional public services on their behalf. There are many ways that this can be achieved, to some approximation. Local development or impact fees, regulatory mandates from zoning boards that require property developers to build roads, water and sewerage systems, and other infrastructure and user fees for water, electricity, and other local services are all examples of mechanisms by which the cost of providing public services can be assessed, directly or indirectly, against those for whom these services are provided. The local property tax can also do this, even if somewhat imperfectly. The local property tax, then, may discourage the growth of the local housing stock or of commercial and industrial property, but to some degree this "internalizes" the costs that local residents impose on local governments and contributes to a more efficient pattern of spatial development.

Thus, on efficiency grounds, the local property tax has some potential advantages and some potential disadvantages. The same is true for other *local* taxes, including local income taxes: they create fiscal disincentives that discourage the taxed activity (for example, the earning of income), which generally is harmful to economic efficiency. But they also provide a means by which the costs of local public services can be absorbed by (or distributed to) those whose presence gives rise to those costs, and in this respect they are conducive to efficient locational choices. To the extent that local governments in Kentucky rely relatively more heavily on "income" taxes and less heavily on property taxes, they create a somewhat different set of fiscal incentives, the efficiency consequences of which are also somewhat different. To the extent that local governments in Kentucky rely on *state* government revenues, the costs of local public services are borne by taxpayers throughout the state rather than those who reside in a particular locality. Local taxes then internalize the costs of local public services to a smaller degree, and the locational decisions of households and businesses would be less influenced by these costs.⁸⁶

On vertical equity or ability-to-pay grounds, the property tax is often viewed as less appealing than an income tax, assuming of course that one believes that the income tax, in practice, is reasonably closely correlated with ability to pay. The real economic incidence of the property tax imposed by any single locality, or

⁸⁶ To take just one illustration, there are stronger incentives to develop rural land if the cost of public service provision associated with such development (including not only land-development costs proper, but any services provided to local residents, such as education) is borne by state taxpayers rather than local residents.

even by all localities within a given state, likely falls on property owners only to a limited degree. In the long run, investment in any one locality, or in the entire state of Kentucky, is likely to earn about the same as the rate of return elsewhere in the economy. Although a 3 percent local property tax might at first reduce the net rate of return on investment, homeowners, landlords, and owners of commercial and industrial property will not suffer a lower net rate of return in a single jurisdiction forever. By discouraging investment through property taxation, the size of the local housing stock shrinks, causing rents to rise; the amount of local commercial activity diminishes, causing the prices of locally-provided goods and services to rise; and the less-profitable components of local industrial capacity disappear, until, in the end, local investment earns the same rate of return, net of tax, as can be obtained elsewhere. In this process of adjustment, the real economic burden of the tax is shifted to the consumers of local housing services and other locally-provided goods and services, to local landowners (whose land offers less profitable investment opportunities), and possibly to local workers, whose wages may fall as employment opportunities contract. These adjustments of economic behavior, triggered by the imposition of the property tax and the fiscal incentives that it creates, cause the real burden or incidence of the tax to be shifted from property owners to others.

State and local income taxes produce some of these same effects, as well. As noted in Chapter 1, income taxes reduce the incentives for taxpayers to produce taxable income. They also reduce the incentive to live in a state or locality where income tax burdens are high, and this impact is likely to be more important for households with large amounts of taxable income. If a state or locality must compete for labor, including the labor of households with high incomes, the real economic burden of taxes on high-income households will tend to be shifted to others. The mobility of labor limits the ability of a state or locality to reduce the real income of taxpayers through income taxation.

STATE REGULATION OF LOCAL PROPERTY TAXES: HB 44

In 1979, the Kentucky statutes governing local property taxes were revised in a significant way. Through the enactment of a measure known as HB 44, Kentucky limited the ability of local governments to determine local property tax rates. This limitation remains in effect today.

Under the provisions of HB 44, the property tax rate imposed by a local government—a county, municipality, school district, or other special district—cannot normally be set at a level that would result in an increase in total revenue by more than 4 percent above the revenue collected during the preceding year. From time to time, new local governments, particularly “special districts,” come into existence. These units of government are also subject to HB 44 limits. But because HB 44 applies to annual growth in revenue, it does not restrict the property tax rate for a local government in its first year of operation.

The HB 44 limitations are subject to two important exceptions. First, revenue growth that results from the taxation of “new property” is not subject to this limitation. For example, when a new housing subdivision is built, the extra tax revenue that is received from taxation of the new housing in the year that it is initially

assessed is ignored in determining whether the locality in which it is located is in compliance with the 4 percent limit. Second, a locality can exceed the 4 percent limit, provided that this increase is not overturned by the voters in a special election which may be called in order to challenge it.⁸⁷ This voter-approval requirement obviously allows for more rapid growth in tax revenues, but it also erects a barrier to increases in property tax revenues in the normal course of policymaking.

A regulation like HB 44 can potentially have many important effects on local government finance. (1) It might significantly restrict the amount of property tax revenues that localities collect, in aggregate. (2) Aside from any aggregate impact it may have, it could significantly restrict the amount of property tax revenues for at least some particular localities. (3) It could result in heavier reliance on other local taxes. (4) It could result in the creation of additional special districts.⁸⁸ It would be a challenging task to sort out exactly what impact HB 44 has had in each of these (and other) dimensions since many factors other than HB 44 influence local policy. Nevertheless, it is possible to shed light on at least some of these questions. The following discussion reviews the evidence with regard to (1), (2), and (4). Other local taxes are discussed subsequently.

Aggregate Trends in Property Taxation Since 1979. First, the discussion in the second section of Chapter 2 reveals that Kentucky has collected a relatively small amount of revenue from property taxes, at least expressed in relation to personal income, for quite a long time. Figures 7, 9, and 11 of that chapter also show that the burden of property taxes has been remarkably stable in relation to personal income. The data in those figures begin with 1977, that is, two years prior to the enactment of HB 44. One cannot discern any dramatic immediate impact of this regulation on aggregate local property tax revenues in Kentucky.

Data on Individual Counties, 1998-2000. The aggregate figures can of course be misleading; in particular, the overall picture may be dominated by a comparatively small number of large localities, disguising important effects on other local governments. It is therefore of interest to consider whether any particular local governments seem to have been especially limited by HB 44 constraints. For example, for each year since 1979, one might wish to know how many of the hundreds of local governments in Kentucky imposed property tax rates that exceeded the HB 44 limit (perhaps as a result of special voter approval), how many chose tax rates that placed them at or very close to the 4 percent revenue growth limit, and how many chose tax rates that were well below this limit. If virtually no localities have been at or near the limit, one could reasonably conclude that the limit has not had much effect on local government policies, whereas if the tax rates in

⁸⁷ As discussed further below, there may be other restrictions on the ability of local school districts to raise property taxes, even if voter approval could be secured.

⁸⁸ Because the 4 percent annual growth limitation is stated in nominal rather than real terms (i.e., it is not inflation-adjusted), these impacts might be particularly pronounced during periods of high inflation. Indeed, HB 44 was enacted during an inflationary episode. However, inflation has proceeded at a relatively modest rate since the early 1980s, so this particular aspect of the operation of HB 44 has not been as critical as might otherwise have been the case. The fact that the 4 percent limit is not inflation-indexed does mean, however, that the real impact of the law could be much more significant during a time of rapidly-rising prices.

many or most localities were at the upper limit, this would indicate that the HB 44 limit was a significant restriction.

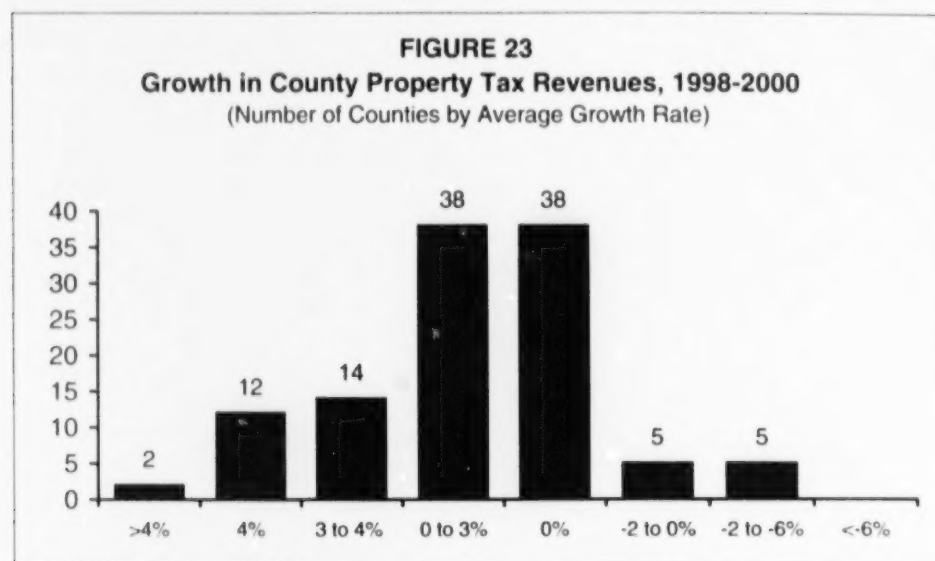
Unfortunately, data have not been collected on a systematic basis that would allow for a thorough examination of this issue. The best data are those that have been collected for the past three years by the Department of Local Government, although these data pertain only to county governments and do not include municipalities, school districts, or other local governments.

To determine the relevance of the HB 44 revenue-growth limit, Figure 23 illustrates the degree to which Kentucky counties have fully, partially, or more than fully exploited the property tax revenues that would be available to them under this limit. To understand this figure, note that the "compensating" tax rate is the tax rate that a county (or other local government) would need to impose in order to raise the same amount of revenue as in the preceding year. Of the counties for which data are available (slightly fewer than the total of 120), Figure 24 shows that 38 of them, on average over the 1998-2000 period, imposed property tax rates equal to the compensating tax rate, that is, tax rates that would enable a county to obtain the same revenue as in the preceding year.⁸⁹ Only 2 counties, on average, imposed tax rates bringing in revenues in excess of the 4 percent limit, 12 chose rates that were just at the HB 44 limit, and another 14 chose rates that brought revenue growth of between 3 and 4 percent. A large number of counties (38) chose tax rates that resulted in revenue growth of between 0 and 3 percent, and a small number of counties (13 altogether) chose tax rates below the compensating tax rate.

These results indicate that approximately 10 percent of counties are at the HB 44 limit in any given (recent) year. Fewer than 10 percent would be at this limit for two or more years in succession. Another 10 percent of counties are close to the limit in a given year. Most counties (about two thirds) choose tax rates that are at or somewhat above the compensating tax rate; these counties could achieve significantly higher revenue growth while remaining within the HB 44 limit, and the remaining 10 percent of counties are still further from the application of HB 44 limits. On balance, it appears that HB 44 limits are not completely irrelevant for county governments, but the number of counties directly affected by these limits in a typical year is rather modest.⁹⁰

⁸⁹ More precisely, the figure shows the growth in property tax revenues exclusive of growth attributable to new property. Thus, 0 percent growth, for example, means that a county applied the compensating tax rate to its assessed valuation. Actual property tax revenues could still vary because of variation in assessed valuation.

⁹⁰ While few counties seem to be subject to HB 44 limits with any frequency, there certainly can be, and are, exceptions. Hopkins County was at the HB 44 limit for each of the years 1998-2000. I am grateful to Hopkins County Fiscal Court Judge R. L. Frymire for informative communications about Hopkins County and about the financing and functions of county governments in Kentucky generally.



Growth in Special Districts. If HB 44 makes it difficult for localities to increase revenues by raising tax rates, there might be important public services that are left unfunded or underfunded. Conceivably, one response to this problem would be to create new special districts which would be given responsibility for providing particular types of services and the authority to raise property taxes on their own. This could either be done in order to provide new types of services or to separate the provision of certain existing services from the rest of the local government budget. In either case, the creation of a new property-tax-financed district would require the imposition of taxes at some initial rate which would be unconstrained by HB 44. In subsequent years, the district would then face the same limits on revenue growth as other local governments, but, compared to the situation prior to its creation, the total potential property tax revenue within the area served by the district and by other local governments (the county or one or more municipalities) would be higher by an amount equal to the revenue collected in the initial year, augmented by up to 4 percent in subsequent years. The continuous creation of new special districts would offset and could theoretically completely eliminate any impact of HB 44.

Interestingly enough, the number of special districts in Kentucky (measured using the standards of the U.S. Bureau of the Census) did rise markedly around the time that HB 44 was introduced. However, as shown in Table 13, the biggest increase in this respect actually occurred *prior to* the 1979 enactments, between 1972 and 1977. The number of special districts has *fallen* by approximately one third since that time. As it happens, Kentucky's experience tracks a nationwide trend, with a major increase in the number of special districts in the mid-1970s followed by a decade of modest growth and then a period during which the number of special districts declined.

TABLE 13
Special Districts, Kentucky and U.S., 1972-1997

Special Districts: Kentucky			KY Special Districts as % of Total U.S.	Special Districts: U.S.	
Year	Number	% Change		Number	% Change
1972	446		1.87 %	23,885	n/a
1977	956	114.3 %	1.84 %	51,974	117.6 %
1982	1,030	7.7 %	1.79 %	57,442	10.5 %
1987	1,116	8.3 %	1.90 %	58,854	2.5 %
1992	986	-11.6 %	2.00 %	49,240	-16.3 %
1997	622	-36.9 %	1.95 %	31,820	-35.4 %

Source: U.S. Census Bureau, Census of Governments, quinquennial

Tracking the *number* of special districts is obviously a rather different matter than tracking the amount of *revenue* they receive. Further analysis might reveal some interesting impacts of HB 44 on the types of special districts that have been created (or eliminated) over time, and the very definition of a special district is a subject worthy of additional study. But the data presented here provide at least a preliminary indication that HB 44 has not resulted in a dramatic proliferation in the number of special districts in Kentucky. Quite aside from HB 44, the data in Table 13 suggest that it would be of considerable interest to understand exactly what forces are at work in determining the number of special districts, not only in Kentucky but throughout the nation.

Conclusion. Has HB 44 imposed a significant limitation on the ability of local governments in Kentucky to raise revenues? The evidence presented above is mixed. In aggregate terms, it appears that property taxes in Kentucky were not dramatically affected by the imposition of HB 44. Since that time, property tax revenues have grown approximately in proportion with income. Furthermore, they have grown approximately in proportion with local property tax revenues elsewhere in the country. Conceivably, the aggregate amount of property tax revenues collected by local governments might have been quite different in the absence of HB 44. If so, however, this would have entailed a departure from Kentucky's traditionally limited reliance on property taxation.

There is very limited information on the extent to which HB 44 limits have affected individual local governments. During the most recent three years, it appears that HB 44 limits may have impinged directly on fewer than one fifth of the county governments—a small but significant proportion of the total. Of course, HB 44 could affect local government fiscal policies in more subtle ways. For example, it could encourage counties not to cut taxes when they might otherwise have done so, for fear of not being able to raise taxes sufficiently in the event of higher future revenue needs. A much more detailed and comprehensive analysis would be required to determine whether these types of effects may be present.

There have been substantial changes in the number of special districts in Kentucky during the period since (and before) the enactment of HB 44. It is difficult

to see direct evidence of any impact of tax limitations on the tendency to create (or eliminate) special districts.

Overall, then, the available evidence does not suggest that property tax limitations have had a major impact on local government finance in Kentucky. These limitations probably have had significant effects in some instances, although even in cases where it appears that counties have fully utilized the local property tax there remains an open question as to *how much* higher their tax rates would have been in the absence of HB 44. Collection of additional information, carrying county-level data back in time and extending the data to include local governments other than counties, would be very helpful in obtaining a clearer picture of the potential impact of HB 44 on local government fiscal policies.

LOCAL INCOME TAXATION

Current Utilization of Occupational Taxes by Counties and Municipalities. Kentucky's local governments rely to an unusual degree on taxes that the U.S. Bureau of the Census classifies as "income" taxes. These taxes are more properly described as "occupational license fees" or "occupational license taxes." They are not levied on "income" as it is measured for purposes of the Kentucky income tax, but rather on either or both of (1) wages, salaries, and other compensation of employees and (2) the net profits of businesses, trades, occupations, or professions. In contrast to the state (and federal) personal income taxes, the occupational license taxes are not applied to such forms of income as dividends, interest, or capital gains received by households, nor do these taxes include any personal exemptions or deductions.

There is a complex system of regulations that determine whether any particular type of local government may use an occupational tax, and if so, at what rate the tax may be applied. Table 14 provides a concise summary of the main features of this system.⁹¹ Note that counties can impose rates that exceed the usual maximum, subject to voter approval if special elections are called for this purpose. The limits on local use of occupational taxes are similar in this respect to those that apply to the use of the property tax, as discussed above.

⁹¹ This table only provides a basic outline of the rules governing local taxes. The *Kentucky Revised Statutes* may be consulted for additional details.

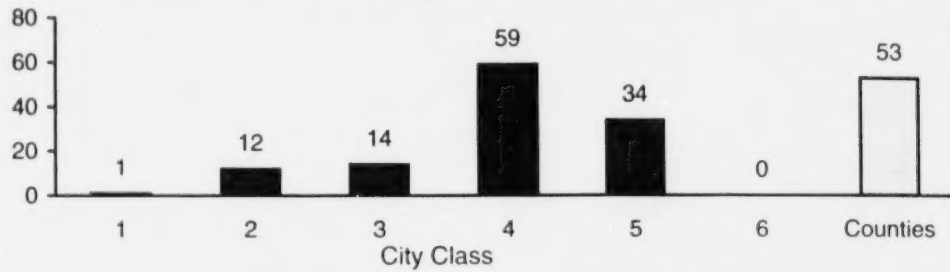
TABLE 14
Occupational License Taxes by Government Unit

Government Unit	Size (where applicable)	Maximum Tax Rate
School Districts	<i>Within counties of:</i>	
	≥300,000 (Jefferson)	0.75%
	<300,000	0.50%
Counties	≥300,000	1.25%
	≥30,000	1.00%
	All Counties	0.50% increments for new programs with voter approval
Cities: 1st Class	≥ 100,000 (Louisville)	1.25%
Cities: 2nd 5th Class	NA	Rate not restricted
Cities: 6th Class	< 1,000	Occupational Tax Prohibited
Mass Transit	NA	1.00%

Information regarding the utilization of occupational taxes by municipalities and counties is presented in Figures 24 and 25.⁹² Mid-size municipalities account for the greatest number of such taxes. In general, larger municipalities are more likely to impose such taxes. Somewhat fewer than half of all counties in Kentucky impose an occupational tax. As shown in Figure 26, occupational taxes are most frequently levied at rates in the 1 to 2 percent range; in no case does the tax rate exceed 3 percent. Figure 27 shows that occupational tax rates tend to be somewhat higher in mid-size cities, though comparatively few have rates in excess of 2 percent. Recall from Table 14 that the tax rates for cities in classes 2-5 are not restricted by the state, so much higher rates than those shown in Figure 27 could, in principle, be observed.

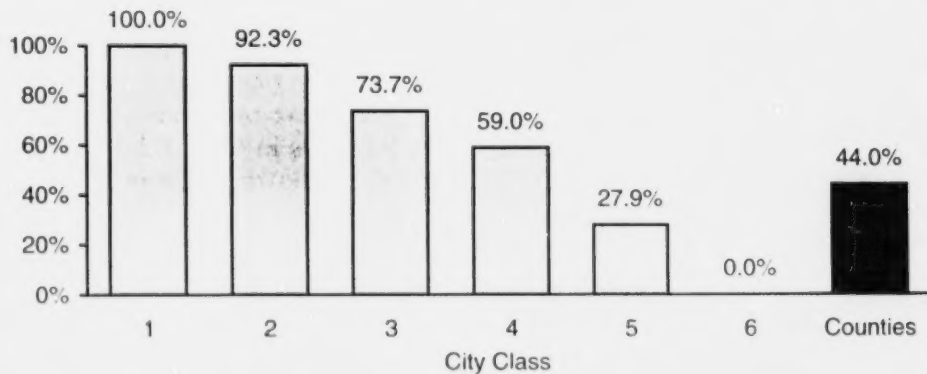
⁹² Since the financing of local school districts is treated in more detail in the next section, the following remarks focus on municipal and county governments.

FIGURE 24
Number of Municipalities Imposing Occupational License Tax, by City Class and County



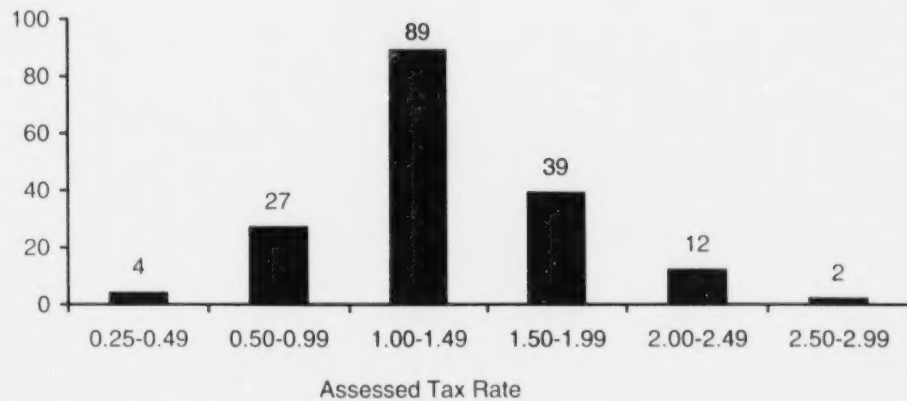
Note: Cities of the 6th class are prohibited from imposing an occupational license tax.
 Sources: Kentucky Revised Statutes: 81.010 and KYCPA data from kycpa.org

FIGURE 25
Percentage of Municipalities Imposing Occupational License Tax, by City Class and County



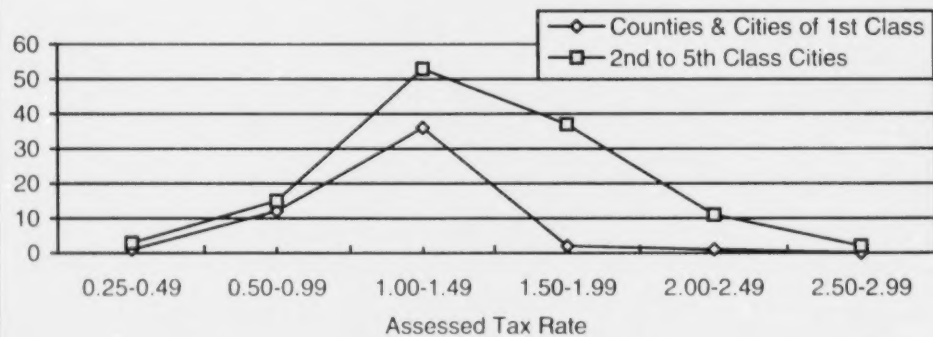
Notes: Cities of the 6th class are prohibited from imposing an occupational license tax.
 Sources: Kentucky Revised Statutes: 81.010 and KYCPA data from kycpa.org

FIGURE 26
Number of Municipalities Imposing Occupational License Tax, by Assessed Rate



Source: KYCPA data from kycpa.org.

FIGURE 27
Occupational License Tax, by Municipality Type and Assessed Tax Rate



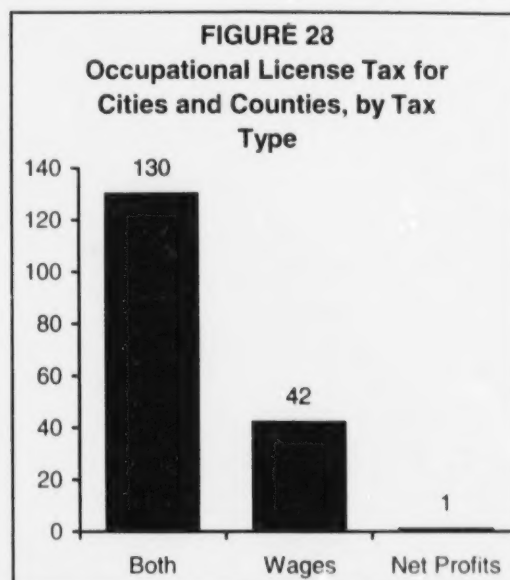
As for the *type* of occupational tax that is used by local governments, Figure 28 reveals that most tax both the earnings of workers and the net profits of businesses. A significant number, however, tax only wage income.

Equipped with these basic facts about the use of occupational license taxes by county and municipal governments, we may tentatively draw several conclusions. First, many but not all of these governments do utilize the occupational tax. For those localities that do not use this tax, there is unexploited potential to raise additional tax revenues if desired. The same is true for most municipalities, which are not subject to statutory limits on the tax rates that they may impose. County governments could in principle impose taxes well in excess of the usual 1 percent limitation if they were to obtain special voter approval, and thus they, too, could potentially increase their revenues from heavier use of the occupational tax, though in practice it appears that the statutory limitation has effectively constrained some county governments. Overall, the occupational tax seems to have provided county and municipal

governments with a reasonably flexible source of significant revenues, one that could be exploited more heavily, if needed, in order to meet urgent local priorities.

Some Additional Issues. Employee compensation accounts for a large—in most instances, the major—portion of the occupational tax base. Since the tax is imposed at a flat rate, it is most easily administered by taxing the payrolls of employers. Unless special provisions are made, this method of administration results in the assessment of taxes based on a worker's place of employment rather than place of residence. In the most common situation, workers reside in the same city or county where they work, but there are significant numbers of instances where people reside in one locality and work in another. As a matter of policy, should one locality be able to impose taxes on the residents of another?

Generally speaking, the ability to reach beyond jurisdictional boundaries to impose taxes on nonresidents creates incentives for governments, representing the interests of local voters, to *export* their tax burdens, that is, to shift as much of the burden of financing local services to nonresidents as possible. Aside from the potential inequity that such tax exporting creates, it can also interfere with efficient resource allocation: if the benefits of local services are enjoyed by local residents but the costs are shifted to nonresidents, the former have an incentive to expand services whose benefits fall short of their true costs. However, many local public services, such as police and fire protection, water and sewage services, and access to local transportation, are utilized by nonresidents as well as residents. The commuters who spend the working day in a city not only benefit from public services provided in their place of employment, they (or their employers) impose some



costs on the locality where they work. Again, leaving equity issues aside, this can contribute to inefficient resource allocation. One of the real costs of productive activity is the provision of public services to employers and employees. Employment in a particular location is efficient when the value of what employees produce is at least as great as the value not only of their time but of other resources, including public resources, that are used in the production process. An employment-based tax provides localities with an opportunity to recover the cost of providing public services to those who work within their boundaries.

The occupational tax is based on income rather than on the cost of public service provision. A tax, user fee, or price that is more closely linked to the value of resources used would generally be more efficient than one based on income; for example, it is more efficient to charge for water usage on the basis of the amount consumed, or for bus transportation on the basis of trips taken, rather than through earnings-based taxes. For many public services, however, such pricing schemes are not possible. The occupational tax is an imperfect substitute for cost-based charges, and perhaps it functions as well as any feasible alternative in this respect. In principle, it could certainly be inefficiently overutilized by local governments seeking to capture resources from nonresidents, but there is little evidence available to suggest that this is a major problem in Kentucky.

A related but somewhat different issue concerns the use of the occupational tax in overlapping jurisdictions. Every municipal government is located within the boundaries of a county, and both of these units of government are allowed to impose occupational taxes. Under current state law, a taxpayer who is subject to both county and municipal taxes can credit the municipal tax against any county occupational tax liability. To see the potential implications of this rule, suppose that a county imposes a 1 percent occupational tax on its residents, including those in the county seat and other municipalities within the county. This tax, by itself, would produce a certain amount of revenue. However, given the county tax at 1 percent, any municipality in the county could now also impose a 1 percent tax and in doing so not impose any additional tax burden on its residents (or, to be more precise, on those employed within its jurisdiction). That is, the municipality can in effect transfer the portion of the occupational tax revenues collected within its jurisdiction from the county government to itself. One can also think of this as a sort of revenue-sharing arrangement, where the proceeds of a countywide tax are shared between the county and municipal governments.

This means that a county government, when it imposes an occupational tax, has to anticipate that the revenue thereby produced will come primarily from income produced in the nonmunicipal or unincorporated portions of the county, and that its tax will produce an increase in revenues for the municipalities within its boundaries. This likely creates an incentive for county governments to focus service provision on residents not located in the major cities and towns within their boundaries, which may be quite appropriate. However, insofar as counties are charged with responsibilities that are truly countywide in nature, this arrangement is not conducive to efficient financing.

EDUCATION FINANCE

This section examines in more detail the financing of primary and secondary education in Kentucky. Education finance is a complex subject and it is intimately connected to education policy in general. The discussion below unavoidably and deliberately draws attention to a number of educational-policy issues, but maintains a focus on fiscal policy and certainly does not purport to provide a complete treatment of educational policy in Kentucky, which would go far beyond the scope of the present study.

SCHOOL FINANCE IN KENTUCKY: SOME BASIC FACTS

The financing of elementary and secondary education in Kentucky is very much a shared function of the state, acting principally through the Department of Education, and of the local school districts, of which there are some 176. Education finance in Kentucky was affected in a major way in 1990 with the passage of the Kentucky Education Reform Act (KERA), which included extensive provisions for state financial aid to local school districts, particularly through the program known as SEEK (Support Educational Excellence in Kentucky). In addition to state government financing through SEEK, local school districts also obtain funding from their own sources, principally local property taxes, occupational license taxes, and utility gross receipts taxes. A comparatively small amount of revenue is obtained from the federal government. Overall educational funding has grown quite significantly in the decade since KERA, with an especially large increase in local revenues. Total spending in 2000 amounted to about \$3.8 billion, of which the state contributed about \$2.1 billion, or somewhat more than half.

For a broad sketch of the sources of school funding and their trend over time, see Figure 29. As this figure makes clear, local schools in Kentucky have depended very substantially on state government funding during the past decade, and only slightly on federal government funds.

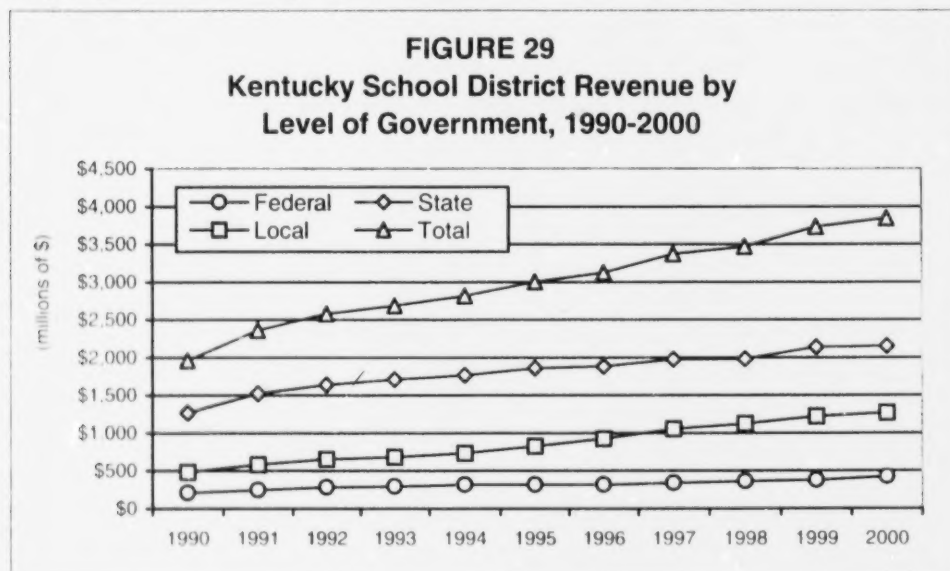
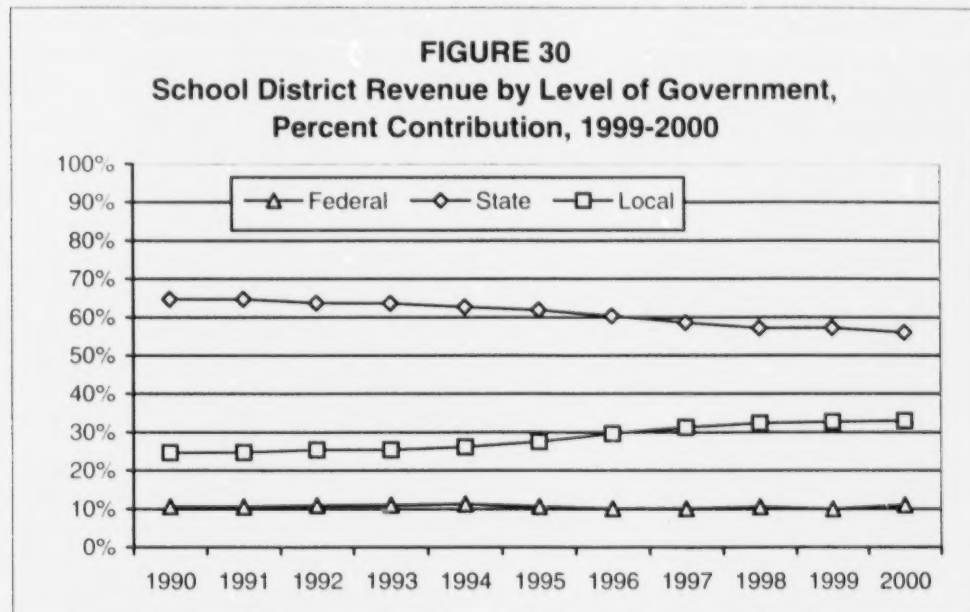


Figure 30 reveals more clearly the *relative* contributions of each level of government to local school finance. It is apparent from Figures 29 and 30 that most of the funding for local education comes not from local resources but from the state government, and that this has been true for quite some time. Federal funds, though not insignificant, contribute comparatively little to the funding of local schools, and are quite stable at about 10 percent of total revenue. One noteworthy trend displayed in Figure 30 is the steady decline in the relative importance of state funding and the corresponding growth in reliance on local revenue sources.



In order to understand better the relative role of state and local revenue sources in financing education, it is necessary to review the SEEK program through which revenue is transferred from the state to the local school districts and to describe in some detail the revenue instruments available to local school districts.

As will be described further below, the SEEK program does not merely determine the amount of educational funding that is distributed to localities, it also affects local funding by affecting the incentive to use local revenue sources. Aside from the overall state-local mix of revenues in educational finance, another key question concerns the local revenue instruments themselves. Do these taxes distort economic behavior? Are they fair? Can local districts use them to meet pressing financial needs? Before attempting to evaluate the system as a whole, some discussion of its component parts is in order.

SEEK FUNDING

The SEEK program distributes funds to local school districts according to a somewhat involved formula, not all details of which are relevant here.⁹³ The key features of the program, distilled to its simplest form, are (1) the SEEK "base" level of funding and (2) a two-tier system that governs funding about the base level.

The SEEK Base. For each school district, a base level of funding is determined; to a first approximation, this is a uniform statewide level of funding per student. This base level is achieved through a combination of state and local funding. First, each local district is required to impose a local property tax of at least 30 cents per \$100 of assessed valuation, i.e., a tax rate of 0.3 percent on property value. The state then supplements this local revenue with transfers that enable each district to achieve the base level of spending per pupil. The base level of transfers from the state depends on how much revenue is produced by the local property tax, irrespective of the use of other revenue sources.

Tier I: 100-115 percent of the SEEK Base. Any school district that elects to exceed the base level of funding by as much as 15 percent is permitted to do so by levying property taxes at rates above the 0.3 percent requirement. Some districts, of course, are "property poor" in the sense that they have relatively little assessed property value per pupil, while others are "property rich." For most school districts operating in the Tier I range (between 100 percent and 115 percent of the SEEK base revenue per pupil), the increase in revenues from higher property tax rates are augmented with additional funds from the state according to an "equalization" formula. These funds are determined in such a way that an increase in the local property tax rate in any district will increase revenue by the same amount as would have been obtained if the district's assessed property valuation per pupil were equal to 150 percent of the statewide average.⁹⁴ The amount of additional state support obtained in this fashion, of course, is relatively modest for "property-rich" school districts but more substantial for "property-poor" ones.⁹⁵

Tier II: 115-130 Percent of the SEEK Base. School districts are permitted to use local revenue sources to increase funding beyond 115 percent of the SEEK base. The state does not, however, provide any additional support for such districts, so any additional revenue that they obtain in excess of the Tier I level must come entirely from local sources. With some exceptions, school districts are not allowed to raise local revenues beyond 130 percent of the SEEK base, however. In

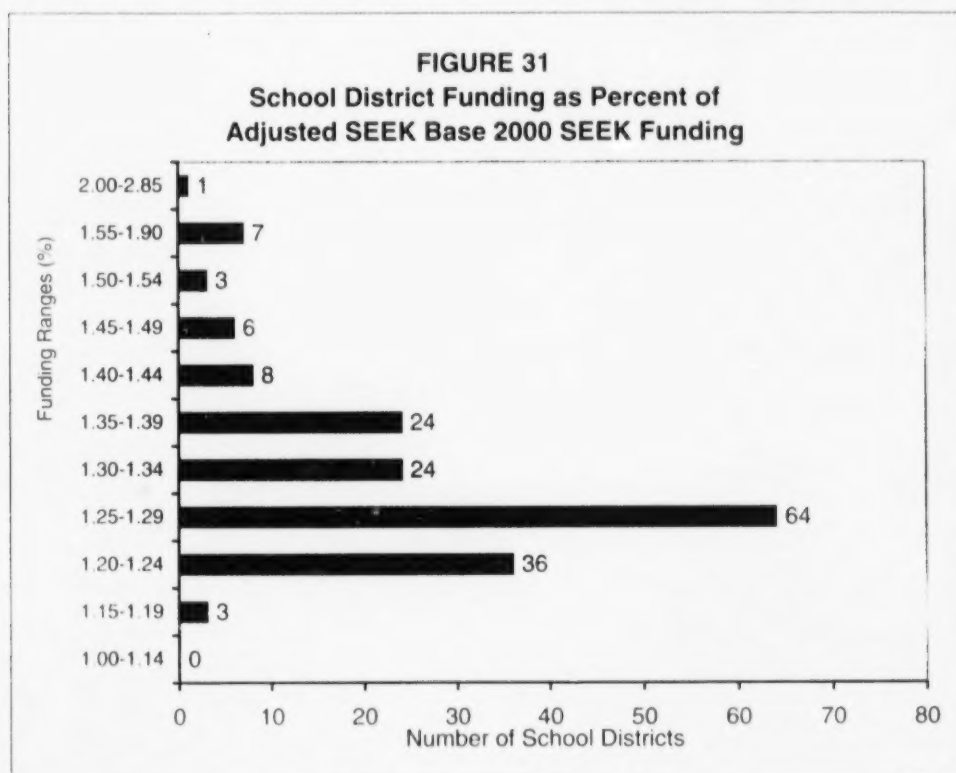
⁹³ The SEEK formula makes special allowances for "at risk" and "exceptional" (disabled) children, for transportation needs, and for students at home or in hospitals. These are among the complexities that are ignored in the following discussion.

⁹⁴ For example, a property-poor district, with an assessed valuation per pupil equal to only 75 percent of the state average, would obtain \$1 of additional state funding for \$1 of additional property tax revenue that it collects, so that the effective local yield from higher tax rates is the same as if the district were property rich, with 150 percent of the statewide average assessed valuation.

⁹⁵ There are six school districts for which the level of assessed property value is greater than 150 percent of the statewide average and which, accordingly, do not qualify for Tier I funding: Anchorage Independent and the districts of Boone, Campbell, Fayette, Jefferson, and Kenton Counties. At present, every school district in the state exceeds the Tier I cap of 115 percent of the SEEK base level of revenue per pupil.

other words, local tax effort to increase school funding is subject to a regulatory cap. The principal exception to this rule is a "grandfather" clause in KERA, according to which no school district would be required to reduce its educational spending. Thus, districts with initially high levels of education spending are permitted to exceed the Tier II cap. At present, some school districts do exceed the Tier II maximum level of spending, as shown in Figure 31.

In summary, from the viewpoint of tax analysis, the crucial elements of the SEEK program are: (1) a minimum property tax requirement for all districts, (2) added financial incentive for modest increases in local tax effort above the minimum with equalizing components built in (Tier I), (3) a range of revenues over which local districts are "on their own" (Tier II), and (4) a cap on local tax effort (130 percent of SEEK base) with special exceptions for a handful of districts.



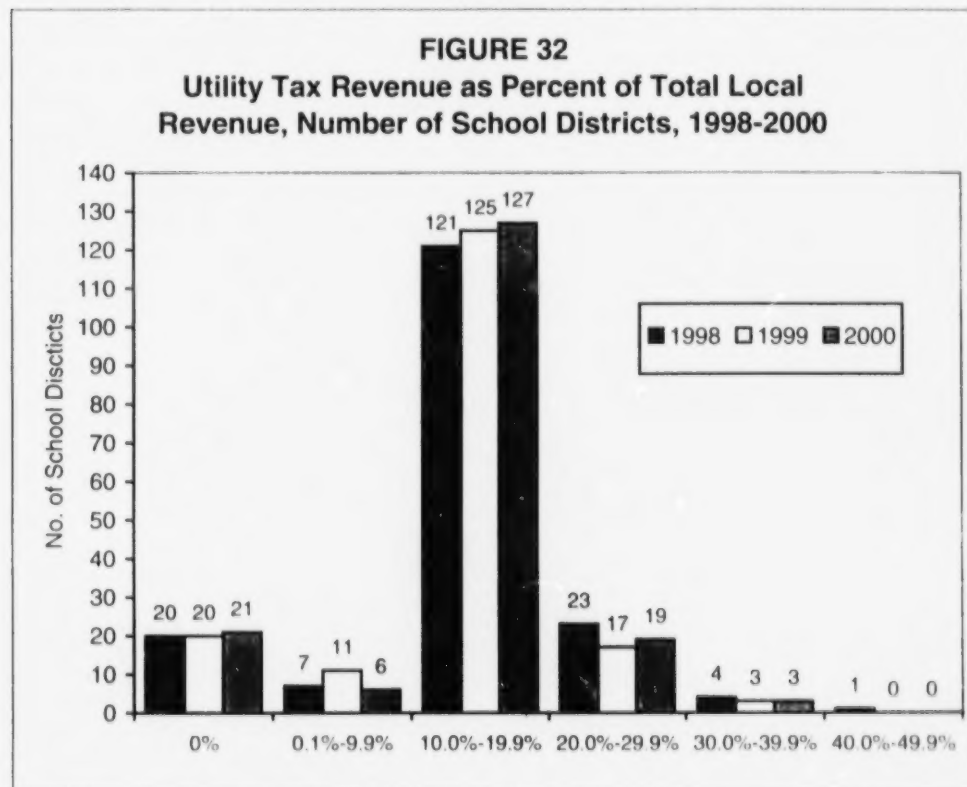
LOCAL REVENUE SOURCES

The main revenue instruments available to local school districts are the property tax, the utilities gross receipts tax, and the occupational tax.

The Property Tax. First, school districts are permitted, and to some extent required (in order to achieve the SEEK base level of funding), to use local property taxes. As previously discussed, they are subject to the same HB 44 limitations on annual property-tax revenue growth as other local governments. Like other localities, school districts can exceed HB 44 limits, though possibly subject to special approval by the voters. Thus, as for other localities, HB 44 may raise political

barriers to tax increases but does not put any absolute limit on the amount of revenue that can be raised from the property tax. However, school districts are subject to strict expenditure limits which do not apply to other localities: any tax increase must not permit revenue growth in excess of the Tier II limit described above, even if local voters are willing to approve higher taxes.⁹⁶

Utilities Gross Receipts Tax. Over 150 school districts use the "utilities gross receipts" tax, a tax on the revenues derived within a locality from telephone services, electrical power, water, gas, cable television, and related services. State law limits the rate of this tax to 3 percent. At the present time, all but 22 of Kentucky's school districts impose this tax, and in only four of these districts does the tax rate fall short of the 3 percent maximum. As shown in Figure 32, this tax accounts for a significant share of school district revenues, amounting to some 10 to 30 percent of revenues for about 140 of the state's school districts.



Since the tax is imposed at its maximum rate of 3 percent in almost all districts, it is, in effect, a statewide levy at a 3 percent rate on utilities, with the revenues accruing to local school districts in proportion to the amount of local utilities revenue. Viewed in this way, it complements the state sales tax by including within the

⁹⁶ The statutory language is clear: KRS 157.440(2) states that local taxes can be increased with the approval of the district's voters, but "[t]he rate that may be levied under this section may produce revenue up to no more than 30 percent of the revenue guaranteed by the program to support education excellence in Kentucky plus the revenue produced by the tax authorized in this section."

sales tax base some intangible items that would otherwise not be subject to sales tax. If one favors a broad-based sales tax, the utilities gross receipts tax has the virtue that it broadens the base, though the 3 percent limit implies that that portion of the base is taxed preferentially relative to the standard tangible-goods tax rate of 6 percent. Unlike the state's general sales tax, the revenues from the utilities gross receipts tax are earmarked for education. Again unlike the general sales tax, the revenue is distributed to the localities where taxable purchases occur, i.e., the localities.

Occupational License Tax. The occupational license tax is another potential source of revenue for school districts, one which is utilized heavily by a handful of districts and not at all by most. Jefferson County obtains over 25 percent of its local revenues from this source, and it accounts for 10 percent or more of local revenues for several other districts. However, only 8 districts in the entire state use this tax. The rate of taxation is limited. For school districts in counties with populations over 300,000 (i.e., only in Jefferson County), the tax rate may be as high as 0.75 percent, whereas for districts in less populous counties, it is limited to 0.5 percent. In those few districts that utilize this revenue source, it produces a significant share of the local financing for education, as shown in Table 15. Boone, Cumberland, Fayette, Scott, and Warren counties impose this tax at the maximum allowable rate of 0.5 percent.

TABLE 15 Occupational License Tax Revenue Collected by School Districts			
School District	1998	1999	2000
Anchorage	\$ 357,292	\$ 383,486	\$ 402,617
Boone County	3,343,566	4,031,695	4,332,054
Cumberland County	130,669	126,629	143,536
Fayette County	17,578,215	18,824,723	21,206,519
Jefferson County	79,018,998	85,242,359	89,122,707
Marshall County	1,060,000	1,060,000	1,100,000
Scott County	1,875,447	2,781,947	3,100,323
Warren County	3,685,000	3,875,000	4,130,000
Total	\$107,049,187	\$116,325,838	\$123,537,756
Average	\$ 13,381,148	\$ 16,617,977	\$ 17,648,251

Source: Kentucky Department of Education

Summary. To summarize some salient points from this overview, we note the following:

- (1) All school districts utilize the local property tax, and this constitutes the principle source of own-revenue for all school districts;
- (2) Virtually all school districts impose the utilities gross-receipts tax at the statutory maximum rate of 3 percent, in effect producing uniform a statewide levy (albeit locally-administered) with revenues earmarked for education; and

- (3) A comparative handful of school districts, including, however, some of the largest in the state, rely significantly on the local occupational tax for a substantial share of revenues, and many of these impose this tax at the maximum allowable rate.

POLICY ISSUES

Fundamental Educational Reform: Public Support for Children or for Schools? Systems of educational finance are always candidates for reform, simply because education policy itself is an important and complex matter. Serious reform proposals should begin with an analysis of fundamental educational goals, on the basis of which rational analysis of funding can begin. There has been an ongoing national debate about the provision and financing of education for a number of years, and Kentuckians may or may not decide to alter the current educational system in major ways. There is presumably broad consensus that primary and secondary education should be generally available to the children of the state. There is probably widespread agreement that the educational opportunities of poor or otherwise disadvantaged children should not be unduly constrained by family circumstances or place of residence. Beyond these basic premises, there is much scope for debate.

To begin with perhaps the most basic question, one may ask what role private schools can or should play in the state's educational system. Public provision of education is frequently supported on the grounds that it is available even to children from poor families who would not otherwise be able to afford education. An alternative and much-debated approach would allow parents to send children to private schools with financial assistance from state or local governments through vouchers, tax credits, or by other means. One simple option would be to allow a per-pupil allowance, like the SEEK per-pupil base amount (\$3,046.33 for 2000-2001), to "travel" with a student and to be made available in whatever school a student attends. If desired, this allowance could be made available only to students from poor families. This amount of funding might be insufficient for some families to take advantage of private schools, but it would undoubtedly result in an increase in private-school attendance and a reduced reliance on public schools. It would not require any change in the amount of state and local tax revenues devoted to education. However, if the essential goal of a fixed per-pupil allowance is to achieve basic equity by ensuring that some level of education is made available to all children, or to poor children, it might also be argued that there is no reason why such allowances should be funded from local sources at all, or from a mix of state government revenues and local property taxes. Other programs that promote equity or redistributive objectives, such as the state's welfare and health care programs, are not funded from local sources. Why should those elements of the educational system that aim to transfer resources in favor of the poor be financed differently from other redistributive programs?

Even if public resources are strictly denied to families whose children attend private schools, the relative importance of public and private education may well shift over time. Parents dissatisfied with public education always have the option, at their own expense, to withdraw children from public schools. The extent to

which this option is exercised will vary, depending in part on the quality of public schools. This possibility is discussed further below.

Equity and Efficiency in Public School Finance. Concerns about fairness in the provision of education, and about the role of education in giving young people a fair chance in life, are perhaps the driving force behind public-sector involvement in education. Concerns about differences in the capacity or willingness of different localities to support education are probably the driving force behind state government involvement in the financing and regulation of local schools. Some localities may have more wealth or income than others and their residents may wish to use some of their additional income to support local schools. Other localities may make education a higher priority in local tax and spending decisions, independently of their wealth or income levels. For example, voters in a community with many young families may be more willing to support higher taxes for schools than one with few children of school age. Voters in a community in which many families use private schools may find that local public education garners less support than otherwise. Parents may place a higher priority on education for their children in regions of the state where the demand for educated workers is high. High-quality education may simply be a norm or tradition in some parts of the state but not in others. For these and a host of other reasons, the local demand for public education varies among local school districts, and the level of education spending chosen by autonomous school districts must therefore also be expected to vary. Because local demands for education vary, the efficient level of provision of public education differs among school districts, and the amount of resources that school districts will choose, if allowed to do so, will vary.

Is it fair or equitable for some districts to spend more on education than others? Views on this question vary. Many would argue that the state government should support school districts that are "resource-poor," that is, districts that have low amounts of taxable property or other resources in relation to the number of students in public school.⁹⁷

Even with state support for "resource-poor" districts, however, some districts are likely to spend more than others. Indeed, the experience since KERA has shown that spending levels per pupil continue to vary among school districts in Kentucky, though most of the spending variation is within the bounds of the Tier II range under the SEEK program. Apparently in order to limit variations in spending still further, or perhaps to strengthen the hand of local taxpayers who wish to resist higher spending on education, the SEEK program puts a cap on the amount that a district can spend (130 percent of the SEEK base), and there are some districts for which this limit appears to be "binding," that is, districts that

⁹⁷ In the SEEK program, a district's resources are measured principally by its assessed property valuation per pupil, a measure that has at least superficial appeal given that property taxes are one important source of school funding. Other sources of funding are also important, however, and other measures of a school district's capacity to finance education might well be preferable. These issues warrant additional analysis and discussion but go beyond the scope of this study.

might be able to secure voter approval to raise local taxes in order to achieve higher spending levels, but are prohibited from doing so.⁹⁸

Some Policy Options. In order to sharpen the policy issues, it is useful to consider some stark policy options.

1. *Elimination of Local School Districts.* If equity in public education is interpreted to mean that education spending per pupil must be identical throughout the state, and if equity in this sense is given priority over all other educational objectives, then local school districts should have no fiscal autonomy whatsoever. Uniform per-pupil expenditures would likely best be achieved by abolishing local school districts. State authorities could then determine the level of per-pupil expenditures, presumably at the level of individual schools throughout the state. In this scenario, state authorities would also determine the appropriate types of taxes, and tax rates, to be used in financing public schools. Statewide property taxes might be used for this purpose, but only insofar as this promotes a more efficient or equitable tax system for the state as a whole.

It is of course impossible to know exactly what uniform level of education spending the state government would choose, but it is quite reasonable to assume that this level would lie somewhere between the highest and lowest levels of expenditures now observed in individual local school districts. Per-pupil expenditures would thus be increased in some schools and decreased in others. This outcome would be inefficient because spending levels in some schools would exceed the amount that parents and other beneficiaries of education would willingly pay and in other schools would fall short of that amount. Those for whom the level of education falls too far below their desired level would still have the opportunity to opt out of the public educational system (unless this were somehow prohibited, in which case the only remaining option for high-demanders would be to leave the state), and it is reasonable to suppose that the number of children in private schools would increase significantly in this case. Since the parents who would switch to private schools would likely desire higher levels of education for their children, the level of political support for public education would be expected to diminish: parents who would support high levels of public education spending when their children are enrolled in public schools would be much less likely to do so when their children attend private schools. Taking this effect into account, the statewide uniform level of public education spending would tend to be lower than otherwise, especially as private school opportunities gradually expand in response to increased demand.

Under this scenario, then, one could anticipate that uniformity in public education would result in efficiency losses as the level of education provision fails to

⁹⁸ The Beechwood Independent School District is an interesting case in this respect. This district spent \$6,339 per pupil in 1999-2000, slightly below the state per-pupil average of \$6,783. It has sought authorization from the Kentucky Department of Education to hold a special election at which voters could decide whether to increase property tax rates by 18 cents per \$100 of assessed valuation, a tax increase which would cause local revenues to exceed the limits imposed under KERA/SEEK. The KDE has indicated that it would be impermissible for the district to increase taxes by this amount, although the voters could, if desired, approve an increase in taxes (up to 14 cents per \$100, in this particular instance) that would keep revenues within these limits. (I am grateful to Dr. F. Bassett, the Superintendent of the Beechwood district, for providing helpful information on this case.)

reflect diverse demands but a gain in equity, at least in the distribution of *public* educational resources. Utilization of private educational options would be expected to increase, with private schools especially serving parents with high educational demands and offering a wider diversity of educational experiences than the public schools.⁹⁹

2. *Elimination of State Involvement in Education.* At the other extreme, one could leave each locality to decide how much to spend on local schools and how to finance these expenditures. Education expenditures in resource-poor localities, or in localities that for other reasons have low demands for education, would be relatively low, while expenditures in richer localities, or in localities that have higher demands for education for other reasons, would be high. This outcome would allow for the greatest amount of adaptation of local policies to diverse demands, improving the efficiency with which education is provided. The demand for private education would diminish, since public schools would offer a wider spectrum of choice. Of course, the wide variations in educational expenditures under this scenario would likely be widely viewed as inequitable.

3. *Blending State and Local Participation.* Neither of the polar extremes outlined in (1) or (2) is likely to be appealing. Current policy reflects the tension between the two: local school districts are allowed some degree of autonomy in setting expenditure and tax policies, but their ability to do so is regulated and the state government finances a large fraction of local spending, presumably resulting in greater uniformity in the provision of education throughout the state. The statewide minimum 0.3 percent property tax levy; the SEEK base level of revenues per pupil; the limits on property, utilities, and occupational taxes; the equalization component of the SEEK formula; and the statewide cap on per-pupil expenditures all potentially contribute to greater uniformity in expenditures per pupil. It is very difficult to ascertain what the real effects of this extremely complex arrangement may be, however.

As already discussed, the combination of local tax effort and SEEK funding has moved all school districts beyond the Tier I range of per-pupil expenditures, establishing an effective statewide minimum. In the Tier-II range, incremental expenditures are financed from local sources. At the margin, then, it appears that the SEEK system is not encouraging most local districts to spend more on education; rather, its principal effect is probably (a) to substitute state funds for local revenues, increasing the overall amount of personal income and sales taxes paid by Kentuckians and reducing the amount paid in local property and other taxes, and (b) to redistribute income from residents of school districts with high amounts of property valuation per pupil to those with low amounts. These effects may or

⁹⁹ The interplay between private and public educational systems is complex and not fully understood. To cite one importance case, gradually accumulating evidence suggests that a 1973 decision by the California Supreme Court, mandating greater uniformity in school funding, led to a much larger role for the state government in school finance. This may have contributed to political support for Proposition 13, a well-known property tax limitation measure. Erosion of local financing for schools and greater uniformity in spending then seems to have contributed to a decline in per-pupil expenditures in California relative to the rest of the country and to growth in private-school enrollments during the 1980s and 1990s. Similar findings have been reported for other states.

may not be desirable, but in any case they are rather incidental to education policy, and it is worth considering whether they constitute important policy objectives in themselves.

There are several school districts that appear to be at or near the absolute limits of per-pupil expenditures allowed under the SEEK program. If greater uniformity of expenditures is desired, these limits could be tightened, reducing the amount of spending in districts at the upper end of per-pupil expenditures. The equity case for holding down school expenditures seems to be much weaker than that for ensuring that statewide minimum spending levels are attained, however. On efficiency grounds, such limits may be harmful.

Assuming that some reliance on local tax effort and some variation in local spending is to be allowed, one can ask whether the revenue instruments available to local school districts are appropriate. The property tax and the occupational income tax both offer local districts the potential to raise significant amounts of local revenues. Whether either should be subject to limits on allowable tax rates or on annual tax revenue growth is certainly questionable. In the case of the occupational tax, the limits appear to be irrelevant in most cases, since very few districts have chosen to utilize this tax to the maximum extent allowed. In cases where these limits do actually constrain local educational spending, the important questions to ask are whether additional educational spending and additional taxation imposes harm on the rest of the state, and whether they cause inequities. In general, it would appear that most of the benefits and costs of increases in education spending fall on local residents and that there is little harm done to the rest of the state when a locality's residents elect to tax themselves more heavily in order to spend more on local schools. On equity grounds, the issue of primary concern is presumably educational expenditures rather than tax burdens, and tax limits are not likely to provide an effective way to limit expenditure variations.

To illustrate this point, consider the situation of the five school districts which, in 2000, were applying the highest allowable occupational and utilities tax rates. One might anticipate that districts that are utilizing these taxes to the maximum degree might have unusually high levels of per-pupil spending. In fact, as Table 16 shows, these districts do actually raise substantially more per-pupil revenues (\$2,854) than other school districts in the state (\$1,705). However, these districts receive less in state support than others (\$3,234 vs. \$4,203 for other districts), so, in the end, the total revenues per pupil in these districts are almost identical to (actually, slightly *less* than) the statewide average. For these school districts, at least, higher local occupational and utilities taxes have not resulted in higher expenditures per pupil. The caps on occupational taxes and utilities taxes are potentially limiting the amount of revenues raised within these districts, and removal of these caps might allow them to increase their local revenues. These districts, on average, are not at the upper end of per-pupil expenditures in the state, and it appears therefore that these particular tax rate limits are not contributing to greater equality of per-pupil spending.

TABLE 16
Per-Pupil Expenditures for School Districts Levying Maximum
Occupational License & Utility Tax Rates in 2000

School District	Local Per Pupil Expenditure	State Per Pupil Expenditure	Federal Per Pupil Expenditure	Total Per Pupil Expenditure
Boone County	\$3,657	\$2,326	\$303	\$6,286
Cumberland County	1,163	4,613	863	6,639
Fayette County	4,362	2,567	554	7,483
Scott County	2,880	3,358	526	6,763
Warren County	2,206	3,308	518	6,032
Average	2,854	3,234	553	6,641
Average, All Other School Districts	1,705	4,203	803	6,712

As a final observation, the utilities gross receipts tax appears to be a rather odd instrument for the financing of local education. Since it is in practice imposed at its maximum 3 percent rate almost everywhere in the state, it does not provide a means by which local districts can expand their expenditures at the margin. Arguably, the 3 percent limit should be eliminated so as to increase the ability of school districts to respond to local demand. However, local variations in the utilities tax would create substantial administrative and compliance difficulties for taxpayers; furthermore, the tax is not very transparent and bears little relationship to the activities that it is financing. A better alternative might be to remove the local utilities tax altogether and replace it with a state-administered tax at a uniform rate of 3 percent or perhaps at the general sales tax rate of 6 percent, using the additional state revenues for general state purposes or possibly including this revenue in the transfers made by the state government to local school districts. The case for elimination of the local utilities tax would be strengthened if it were accompanied by relaxation on local use of other major revenue sources, especially the property and occupational taxes, so that local districts would be able, if desired, to make up lost utilities tax revenues from other sources.

7

THE IMPETUS FOR TAX MODERNIZATION

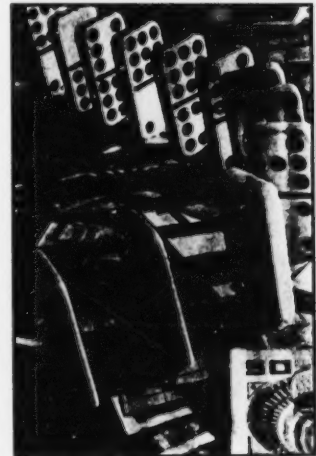
Economic, Demographic, and Political Change

By Michael T. Childress

A number of economic, demographic, and political trends suggest that Kentucky's state and local system of revenue gathering might not be adequate over the long-term. Individuals are receiving a greater portion of their income from nontaxable sources. Consumers are purchasing an increasing amount of untaxed services and avoiding the use tax through Internet or catalog purchases. The aging of the population also will reduce some state and local tax receipts while increasing some expenditures. Kentucky's state and local tax system will begin to feel the effect of these long-term structural economic and demographic changes before many other states.

The focus of more than one recent task force and unsuccessful initiative, the difficult issue of tax reform is likely to remain a priority for Kentucky policymakers and citizens. Recent revenue shortfalls and changing consumer behavior have raised questions about the adequacy of our current tax structure, just as a number of private nonprofit organizations have repeatedly questioned its fairness to low-income taxpayers.

Generally, tax policy experts agree that the ideal state tax system should: (1) provide appropriate (i.e., adequate) and timely revenues; (2) distribute burdens equitably; (3) promote economic efficiency and economic growth (i.e., be competitive with those in nearby states); (4) be easily administered; and (5) ensure accountability.¹⁰⁰ Yet, because of economic changes, demographic shifts, and changing social priorities, a state and local tax structure can slowly evolve into a less-than-optimum system.



¹⁰⁰ *Financing State Government in the 1990s* (National Conference of State Legislatures and National Governor's Association, 1993) 16. Also, refer to this volume, Chapter I, "Tax Reform in Kentucky: An Overview of Principles and Practice."

104 FINANCING STATE AND LOCAL GOVERNMENT

In this chapter we present data on the state and local tax system in Kentucky and discuss changes in the state's economy and demographic structure that are affecting this system. More than half of the combined state and local tax revenue in Kentucky comes from two sources: the individual income tax (or the occupational tax at the local level) and the general sales and use tax. However, the adequacy and efficiency of the state's tax system will be affected as economic and demographic changes unfold. These structural changes include:

- *The gradual shift in personal income away from taxable sources (e.g., wages, salaries, and proprietors' income) and toward mostly nontaxable sources (e.g., transfer payments and nontaxable employee benefits)*—Obviously, this shift is important because the state is highly dependent upon the individual income tax for general fund receipts (44 percent in FY 2000).¹⁰¹ And at the local level, the occupational tax accounts for more than a quarter of tax collections.
- *The transition from a goods-producing economy to a service-providing economy*—The mix of personal consumption among consumers has gradually shifted from goods to services. This is important because sales or use tax is due on most goods, but most services are not subject to taxation. And sales and use tax are the second most important source of state general fund revenue (35 percent in FY 2000).¹⁰²
- *The rise of "mail order" or remote retail sales, which includes Internet and catalog purchases*¹⁰³—These types of retail sales have steadily increased as a percentage of total retail sales, and it is widely believed that few people pay the taxes due on these purchases.
- *The aging of the population*—Kentucky's changing demographic structure will affect all major state and local taxes as well as future expenditures. Moreover, it will affect federal spending priorities in a manner that will ripple throughout the nation's state and local governments.

SOURCES OF TAX REVENUE FOR STATE AND LOCAL GOVERNMENT

Overall, the structure of state and local tax systems in Kentucky differs markedly from the average state. In this section we discuss the sources of state and local government tax revenue.

State General Fund Receipts. An estimated 77 percent of the total tax collections in Kentucky are made at the state level compared to an average of about 61 percent nationally. The two major sources of Kentucky's general fund receipts are the individual income tax and the sales and use tax. Between them, they account

¹⁰¹ Kentucky Revenue Cabinet, *Annual Report 1999-2000*, 15 Dec. 2000, 14 Feb. 2001 <<http://www.state.ky.us/agencies/revenue/pdf/annualreport99-00.pdf>>.

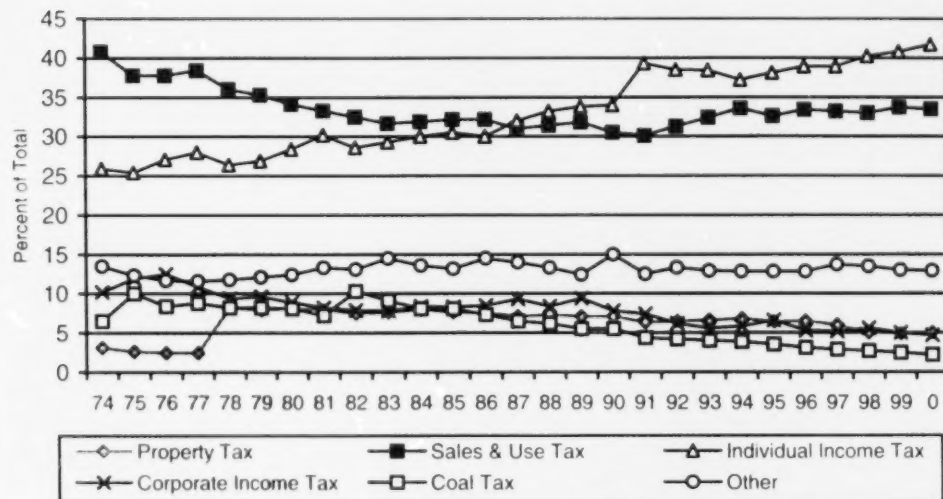
¹⁰² Ky. Revenue Cabinet.

¹⁰³ Mail order sales include those placed by mail, phone, or electronically (over the Internet) without the person who places the order coming to the point of sale. Refer to Table No. 1288, *Statistical Abstract of the United States, 1999* (Washington: U.S. Census Bureau, 1999).

for about 75 percent of state general fund receipts. However, their relative importance has changed dramatically over the past 25 years.

Kentucky's general fund receives a smaller percentage from the sales and use tax and a higher percentage from the personal income tax than it did 25 years ago. In the mid-1970s the individual income tax comprised about 25 percent of general fund receipts while the sales and use tax accounted for around 40 percent. However, by fiscal year 1999-2000 the individual income tax comprised almost 42 percent of general fund receipts while the sales and use tax had declined to just over 33 percent (see Figure 33).¹⁰⁴ And if the general sales tax rate had not been increased from 5 to 6 percent in 1990, the trend in sales tax revenue (as a percentage of total receipts) would no doubt have been a far sharper decline.

FIGURE 33
General Fund Receipts by Major Sources, 1974-2000



Source: Kentucky Finance and Administration Cabinet and Kentucky Revenue Cabinet

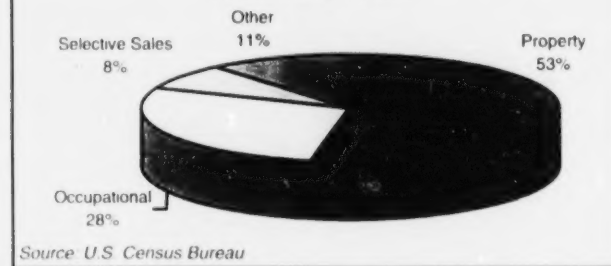
Local Tax Revenue. An estimated 23 percent of total tax collections in Kentucky are made at the local level compared to a U.S. average of about 39 percent. More than one half of the tax revenue for local governments in Kentucky comes from property taxes, around 8 percent is in the form of selective sales taxes,¹⁰⁵ and more than a quarter issues from occupational or payroll taxes (see Figure 34).¹⁰⁶

¹⁰⁴ These data are from two sources. The 1974 to 1991 data are from the Kentucky Finance and Administration Cabinet, as presented by William Hoyt, "Trends in Kentucky Taxes and Their Implications for Future Tax Policy," in *Exploring the Frontier of the Future* (Frankfort, KY: Kentucky Long-Term Policy Research Center, 1996) 243-53. The data from 1992 to 2000 are from various Kentucky Revenue Cabinet annual reports (see footnote 94).

¹⁰⁵ Selective sales taxes include those on alcoholic beverages, amusements, insurance premiums, motor fuels, pari-mutuels, public utilities, tobacco sales, and other selective sales taxes.

¹⁰⁶ Author's calculation based on data from *State and Local Government Finance Estimates, by State: 1996-1997*, U.S. Census Bureau, 6 March 2001. The 1995-96 data are available online at

FIGURE 34
Sources of Local Tax Revenue in
Kentucky, 1997



The extent to which these sources of state and local tax revenue remain robust into the future will be dependent upon changes in Kentucky's economic and demographic structure, the effects of these changes on Kentucky's tax system, and the response of policymakers.

SHIFTS IN PERSONAL INCOME

The composition of personal income can exercise a large effect on state and local revenue growth since the personal income tax combined with the occupational tax constitutes the largest portion of Kentucky's state and local revenue receipts.¹⁰⁷ Over the last several years Kentucky has experienced a shift in the composition of personal income that has affected revenue adequacy, according to the 1995 Kentucky Commission on Tax Policy.¹⁰⁸ And this shift is expected to continue into the future.

The percentage of total personal income by various types is shown in Table 17. In 1960, wages, salaries and proprietors' income comprised 76 percent of total personal income in Kentucky. Dividends, interest, and rent, which are generally subject to taxation, made up another 12 percent. The final two categories, other labor income and transfer payments, which are essentially nontaxable, made up the remaining 12 percent.

<<http://www.census.gov/govs/estimate/96stlss1.xls>>. Local governments includes counties, cities, school districts and special districts.

¹⁰⁷ Refer to Table 25. The individual income tax, which includes the local occupational tax, comprises 31.2 percent of Kentucky's state and local tax revenue. The next largest category, the general sales tax, comprises 21.2 percent.

¹⁰⁸ Kentucky Commission on Tax Policy: *A Blueprint for Comprehensive Reform*, 15 Nov. 1995: 22.

TABLE 17
Sources of Kentucky Personal Income, 1960-1999

Year	Total Personal Income (\$ Millions)	Percentage of Total Personal Income				
		Wages and Salary	Proprietors' Income	Dividends, Interest, and Rent	Other Labor Income	Transfer Payments
1960	\$ 4,934,676	59.1%	17.2%	11.8%	3.2%	8.7%
1965	\$ 6,689,014	59.5	16.1	12.0	3.8	8.6
1970	\$10,396,416	61.2	12.5	10.9	4.9	10.6
1975	\$17,644,186	56.8	10.9	10.9	6.9	14.4
1980	\$31,100,952	54.6	9.4	13.5	8.2	14.3
1985	\$44,319,264	51.4	9.2	17.0	7.9	14.4
1990	\$59,579,011	52.0	7.6	17.6	8.0	14.8
1995	\$77,793,001	52.1	6.2	16.5	8.3	16.9
1999	\$96,746,674	53.3	6.2	17.7	6.7	16.1

Source: U.S. Department of Commerce, Bureau of Economic Analysis, CD-ROM, *State Personal Income, 1969-98*. Data for 1960, 1965 and 1999 were obtained from the Bureau of Economic Analysis web site. Refer to SA05 Personal Income by Major Source and Earnings by Industry—Kentucky, 7 Feb. 2001 <<http://www.bea.doc.gov/bea/regional/spi/>>.

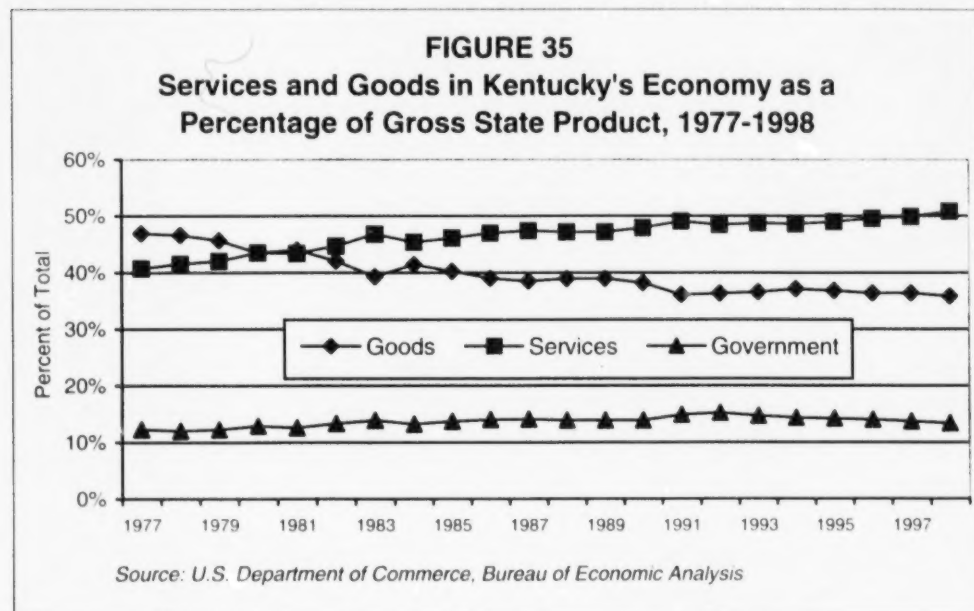
By 1999, however, wages, salaries, and proprietors' income had declined to just under 60 percent of total personal income. Dividends, interest, and rent increased to about 18 percent of personal income, which was not enough to offset declines in wages, salaries, and proprietors' income. The remaining categories of other labor income and transfer payments nearly doubled as a percentage of total personal income from 12 to 23 percent. Other labor income consists of employer contributions to health insurance, welfare, and retirement funds, and transfer payments consist of government programs like Social Security, Medicare, Temporary Assistance for Needy Families (TANF), and Supplemental Security Income (SSI) payments (to name a few).

The changing nature of personal income is important because of the structure of Kentucky's tax system. As illustrated in Figures 33 and 34, the individual income tax is the most important source of state general fund receipts, and the occupational tax is the second most important source of local tax revenue. If the composition of personal income continues to shift toward nontaxable sources and the tax structure remains the same, then future revenue problems will likely develop.

TRANSITION FROM GOODS TO SERVICES

Despite recent reports of a "New Economy" in Kentucky, economic activity has been changing here for the last several decades. Figure 35 shows how Kentucky's economy has been shifting away from the production of goods and toward the provision of services. The data in this figure measure the major sectors

in Kentucky's economy as components of the total gross state product (GSP).¹⁰⁹ In the late 1970s, services accounted for about 40 percent of Kentucky's economic output, but in the early 1980s the provision of services contributed more to the state's economy than the production of tangible goods. And by the late 1990s services accounted for over 50 percent of Kentucky's economy.



This economic shift from goods to services has also been manifested in the changing mix of personal consumption expenditures over the last several decades. Table 18 illustrates the changing consumption patterns for the typical American consumer. In 1960, durable and nondurable goods accounted for 34 percent of personal consumption while services accounted for 25 percent. However, by 1999 services constituted 43 percent of personal consumption while durable and nondurable goods made up 24 percent.¹¹⁰

¹⁰⁹ Goods-producing industries include agriculture, mining, construction, and manufacturing. Service industries include: transportation and utilities; wholesale trade; retail trade; finance, insurance and real estate; and services. Data are from the Bureau of Economic Analysis, 8 Feb. 2001, <<http://www.bea.doc.gov/bea/regional/gsp>>.

¹¹⁰ The 1999 data are estimated from U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, 14 Feb. 2001 <<ftp://ftp.bls.gov/pub/special.requests/ce/standard/1999/region.txt>>.

TABLE 18
The Changing Mix of Personal Consumption Expenditures,
1960, 1990, and 1999
 (Percent of Total Consumption Expenditures)

	1960	1990	1999
Food	25%	16%	14%
Housing	15%	15%	19%
Services	25%	42%	43%
Nondurables	21%	16%	12%
Durables	13%	11%	12%

Source: The 1960 and 1990 data are from the Federation of Tax Administrators, as cited in *Financing State Government in the 1990s*. The 1999 data are estimated by the author from the U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey data.

Clearly, this economic shift has affected the amount of sales and use tax revenues. As described by the *Kentucky Commission on Tax Policy*, "Kentucky imposes a sales tax on the purchase of 'tangible personal property,' which applies to items like clothing, appliances, and furniture. But when the purchase is for a service, like a haircut, dental examination, car repair, or attorney services, the sale is not subjected to a tax."¹¹¹ Obviously, if the state's economy and consumption patterns continue to tilt away from goods and toward services, the sales and use tax base will slowly diminish unless the sales and use tax rate is increased or the sales tax base is widened to include some services. And economists observe that, in general, a lower rate on a wider base is better than a higher rate on a narrower base.¹¹²

RISE IN REMOTE SALES

Complicating the mix of changes in consumer buying is the dramatic rise in remote shopping. Americans are buying more and more items from catalogs, the Internet, and home shopping networks on television. The National Mail Order Association along with Marketing Logistics Inc. estimate that in 1998 U.S. consumer mail order sales reached \$185 billion. Of this total they estimate that consumer Internet purchases accounted for \$5.6 billion.¹¹³ Mail order sales have been increasing faster during the decade of the 1990s than total retail sales and the subset of retail sales that closely approximates nondurable goods.¹¹⁴ Nondurable goods such as apparel are the items most likely to be purchased remotely. During the 1990s total U.S. retail sales increased at an average annual rate of about 5.1

¹¹¹ *Ky. Commission on Tax Policy* 23.

¹¹² Hoyt.

¹¹³ National Mail Order Association, *1998 Mail Order Sales Results*, 8 March 1999, 22 Feb. 2001 <<http://www.nmoa.com/Library/1998sale.htm>>.

¹¹⁴ In this category we include SIC codes 53 (general merchandise group stores), 56 (apparel and accessory stores), 57 (furniture group stores), and 594 GAF (stores which specialize in department store types of merchandise—general merchandise, apparel, furniture, and miscellaneous shopping goods stores).

percent while mail order sales increased by around 8.3 percent.¹¹⁵ As a result of this faster growth rate, mail order purchases comprise a higher proportion of total retail purchases today than in 1990. Table 19 illustrates how mail order purchases increased from about one fifth of nondurable goods to about one quarter during the 1990s.

TABLE 19
Americans Are Spending More of
Their Retail Dollar as Mail Order Purchases

Year	Mail Order (millions)	Purchases of Nondurable Goods* (millions)	Mail Order as a Percentage of Nondurable Goods
1990	\$ 98,190	\$ 471,597	20.8%
1991	107,970	485,439	22.2
1992	110,740	519,230	21.3
1993	118,970	553,046	21.5
1994	129,740	594,247	21.8
1995	141,810	624,389	22.7
1996	151,300	654,999	23.1
1997	169,500	683,245	24.8
1998	185,000	727,160	25.4

*In our nondurable goods category we include SIC codes 53 (general merchandise group stores), 56 (apparel and accessory stores), 57 (furniture group stores), and 594 GAF (stores which specialize in department store types of merchandise—general merchandise, apparel, furniture, and miscellaneous shopping goods stores).

Sources: U.S. Census Bureau, *Statistical Abstract of the United States: 1999*; National Mail Order Association, *Mail Order Sales Results* (various years); U.S. Bureau of the Census, *Annual Retail Trade Survey* (various years).

The rise in remote sales has important tax implications. We have estimated that Internet purchases by Kentuckians will likely result in annual use tax losses that range from \$7.6 million to \$57 million by 2004.¹¹⁶ And the state is likely losing many times this amount as a result of non-Internet mail order sales like catalog purchases. For example, we estimate the cumulative amount of use tax owed on non-Internet mail order sales in Kentucky from 1998 to 2003 at nearly \$600 million.¹¹⁷ As more Kentuckians shop online and order from catalogs, policymakers will be challenged to develop new and better ways to increase the use tax compliance rate. While survey results show that over half of Kentuckians say they are very or somewhat likely to pay their use tax,¹¹⁸ other research suggests that no more than 16 or 17 percent of the use tax owed nationally is actually paid.¹¹⁹

¹¹⁵ Calculated by the author from Census Bureau estimates. U.S. Census Bureau, Table 2, Estimated Total Annual Retail Sales, 23 Feb. 2001 <<http://www.census.gov/svsd/retlann/view/artssal.txt>>

¹¹⁶ Michael T. Childress, "Revenue Implications Grow As More Kentuckians Shop Online," *ForeSight* 7-4 2000: 1.

¹¹⁷ This is the amount owed, not the amount lost. Refer to Peter Schirmer, Kevin O'Neil, and Michael T. Childress, "The Internet as a Virtual Tax-Free Zone: Implications for the State Budget," in *Collecting Taxes in the Cyberspace* (Frankfort: Kentucky Long-Term Policy Research Center, 1999): 20.

¹¹⁸ Childress, "Revenue Implications Grow..."

¹¹⁹ The U.S. Advisory Commission on Intergovernmental Relations reports a rate of 16.5 percent in *Taxation of Interstate Mail Order Sales: 1994 Revenue Estimates*.

While the projected revenue losses from business-to-consumer (B2C) sales are high, they are minor when compared to projected losses resulting from business-to-business (B2B) sales. For example, one estimate places the state's use tax losses due to Internet purchases at \$84 million dollars per year in 2001,¹²⁰ and businesses are believed to account for 90 percent of this total.¹²¹

THE AGING POPULATION

Demographers and budget analysts have been warning policymakers for years that the coming wave of retiring Baby Boomers will wash away projected budget surpluses and erode existing spending priorities. While expenditures for various entitlement programs are expected to increase dramatically, it is already estimated that over half of federal domestic spending outside of interest goes to people 65 and older.¹²² Likewise, the revenue side of the ledger will be affected as an increasing percentage of the nation's population reaches retirement age and becomes eligible for various tax breaks. While much has been written about this issue from a federal perspective, the impact at the state and local levels has not been studied as thoroughly.

It is clear, however, that state and local governments will be affected. For example, individuals over 65 years of age tend to spend less money in general and tend to concentrate more of their expenditures in nontaxed areas such as health care services. As a result, *sales and use tax* collections, which comprise around 33 percent of the state's total general fund receipts, will be affected as the population ages.

Moreover, while many elderly will continue to work, they will get the bulk of their income from *nontaxable* (or virtually nontaxable) sources, like pensions and Social Security. This will affect future *income and occupational tax* collections, which comprise about 42 percent of the state's general fund receipts and more than a quarter of local tax revenue, respectively.

Finally, the Homestead Exemption on real estate for the 2001 and 2002 tax years now exempts from taxation the first \$26,800 of a property's assessed value for property owners who are at least 65 years of age.¹²³ The *property tax* is the main source of local tax revenue in Kentucky, accounting for nearly 54 percent of local tax revenue in 1999. As the Homestead Exemption shields some property owners from taxation, it exposes others to potentially higher levels of taxation and under some circumstances could lower total property tax receipts.

In the sections that follow, we briefly examine the demographic data on Kentucky's aging population and then discuss in detail how the income, occupa-

¹²⁰ Donald Bruce and William F. Fox, *State and Local Tax Revenue Losses from E-Commerce: Updated Estimates* (Knoxville: Center for Business and Economic Research, University of Tennessee, 2001) 8-9.

¹²¹ See Chapter 4, "Tax Equity in Kentucky," page 49.

¹²² Rudolph G. Penner, "Tax Benefits for the Elderly, *The Retirement Project*, No. 5, The Urban Institute, Washington, April 2000.

¹²³ Ky. Revenue Cabinet, press release, "Homestead Exemption Increases to \$26,800," 14 December 2000, 19 October 2001 <<http://revenue.state.ky.us/pressreleases/pr121400.htm>>.

tional, sales, and property tax could be affected. We conclude with a discussion of how future expenditures might be impacted.

KENTUCKY'S AGING POPULATION

There are at least two important factors regarding the manner in which Kentucky's population is aging. First, Kentucky's population is aging faster than most. Second, some regions of the state will have a much higher concentration of elderly than others. In short, the much-feared aging of Baby Boomers, which will be felt nationally, will be felt more acutely in Kentucky. The Census Bureau ranked Kentucky 28th in 1995 among the 50 states and the District of Columbia in terms

of its population 65 and older. By 2025, however, the state is expected to rank 14th.¹²⁴ Kentucky's 65 and older population is predicted to increase by almost 9 percentage points, from around 12.6 percent to 21.3 percent (see Table 20). From 1975 to 2000, Kentucky's population 65 and older looked similar to that of the nation as a whole. However, beginning in 2005 and continuing at least until 2025, Kentucky will begin to pull away from the U.S. average.

The anticipated shift in Kentucky's population toward more elderly can also be seen in the changing distribution of who heads Kentucky's households. By 2020, individuals 65 and older will be the predominant household in Kentucky

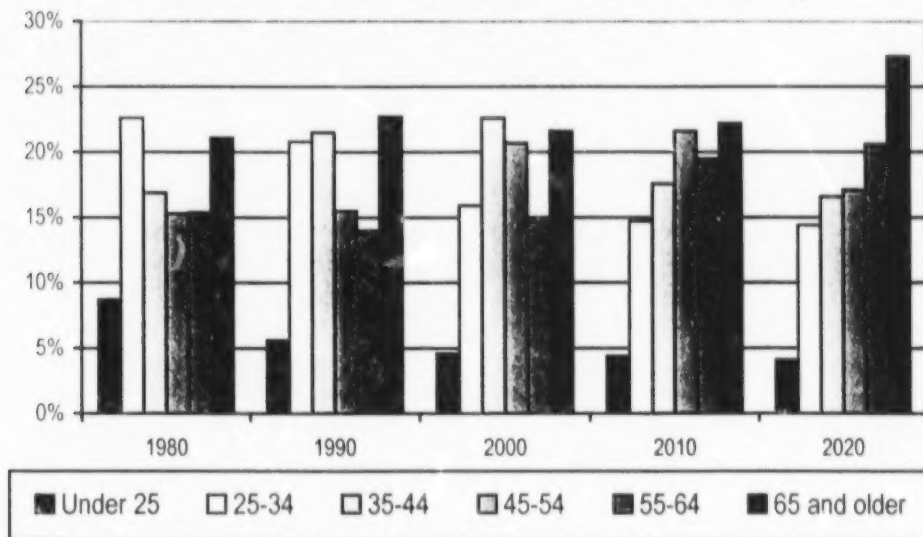
	U.S.	KY
1970	9.8%	10.4%
1975	10.5	10.8
1980	11.3	11.2
1985	11.9	11.9
1990	12.5	12.7
1995	12.8	12.6
2000	12.7	12.5
2005	12.6	13.1
2010	13.2	14.0
2015	14.7	16.0
2020	16.5	18.3
2025	18.5	21.3

Source: U.S. Census Bureau

(see Figure 36). As we will discuss, this rapid increase in the number of households headed by individuals 65 and older is important because they tend to pay less tax.

¹²⁴ "Kentucky's Population Projections: 1995 to 2025," U.S. Census Bureau Web site (2000), 17 Nov. 2000 <<http://www.census.gov/population/projections/state/9525rank/kyprsrrel.txt>>.

FIGURE 36
Household Projections by Age of Head, Kentucky



Source: "Household Forecasts," Kentucky State Data Center, March, 1999

While the whole state is aging, it is not aging uniformly across Kentucky. Some counties have (and will have in 2020) a higher percentage of elderly. For example, as shown in Figure 37, counties in the western and south central part of the state have a much higher percentage of their population in the 65 and older category. Consequently, these counties might begin to feel the effects on their tax bases sooner than others.

FIGURE 37
Percentage of Population 65 and Older, by County



SALES TAX

The sales tax accounts for the largest portion of Kentucky's *combined* state and local tax revenue, almost 37 percent.¹²⁵ Since older citizens tend to spend less money overall and less on taxable items, future sales tax collections will be affected. Table 21 illustrates these points. As can be seen in the row titled "Average Annual Expenditures," households that are headed by individuals 65 and older tend to spend, on average, thousands of dollars less each year than younger households. The one exception is households that are headed by someone under age 25. Moreover, as previously noted, older households tend to spend more money in nontaxed areas, such as health care. The oldest households spend an estimated 12.2 percent of their total expenditures on health care compared to 2.6 to 7.2 percent for the other households. Also, older households tend to spend relatively less at restaurants and entertainment, which are taxed.

TABLE 21
Older Citizens Spend Less Money Overall
and Less on Taxable Items

Age	Under 25	25-34	35-44	45-54	55-64	65 and Over
Average Annual Expenditures	\$21,246	\$32,618	\$38,336	\$41,533	\$33,459	\$24,081
Food at home	8.2%	7.6%	8.4%	7.6%	7.6%	8.9%
Food away from home	7.3	6.1	5.9	5.5	5.2	4.5
Alcoholic beverages	1.3	0.8	0.7	0.7	0.8	0.6
Housing	31.3	32.9	30.9	29.7	30.3	32.2
Apparel	6.0	5.4	5.3	4.9	3.9	3.6
Transportation	24.8	21.8	20.8	20.1	19.1	17.6
Health Care	2.6	3.7	4.5	5.5	7.2	12.2
Entertainment	4.8	4.9	4.8	4.5	5.2	4.3
Other Expenditures	13.7	16.7	18.8	21.4	20.6	16.0

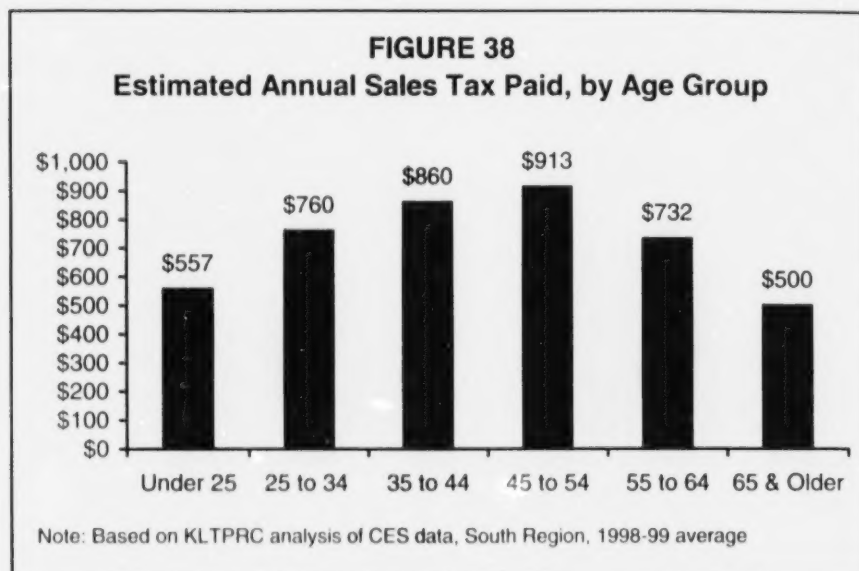
Note: Other Expenditures includes personal care products and services, reading, education, tobacco products, miscellaneous, cash contributions, life, endowment, annuities, and other personal insurance, and retirement, pensions, and Social Security.

Source: Average annual expenditures and characteristics, South, by Age Group, Consumer Expenditure Survey, 1998-1999.

As a consequence of these spending patterns, the state receives less sales tax from the average household that is headed by someone age 65 or older. We estimate, in fact, that the typical 65-and-older household pays about \$500 annually in sales tax—the lowest amount of all age groups (see Figure 38).¹²⁶ Thus, assuming that the elderly of the future adopt spending habits similar to those of today's elderly, total state sales tax collections will be lower than they otherwise would be.

¹²⁵ This includes the general sales tax and selective sales taxes. Selective sales taxes include alcoholic beverage taxes, amusement taxes, insurance premiums taxes, motor fuels taxes, pari-mutuels taxes, public utilities taxes, tobacco sales taxes, and other selective sales taxes. This is an estimate for 1999. The data were downloaded from the U.S. Census Bureau <<http://www.census.gov/govs/estimate/9918ky.html>> on 4 October 2001.

¹²⁶ We use the U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey (CES), South Region data, to estimate the amount of sales tax paid by age of household head. Personnel at the Kentucky Revenue Cabinet examined each CES category and indicated whether sales and use tax is applied in part or in total. We then estimated how much sales tax would be garnered from each age group and expenditure category, accounting for 57 percent of total sales tax receipts.



INCOME AND OCCUPATIONAL TAXES

The income and occupational taxes account for the second largest portion of Kentucky's *combined* state and local tax revenue, about 33 percent.¹²⁷ Since older citizens get most of their income from Social Security and pensions, which are effectively untaxed, future income tax collections will be affected. Consumer Expenditure Survey data show, for instance, that households where the head is 65 or older receive the majority of their income from "Social Security, private and government retirement" as opposed to wages, salaries, or some other taxed source (see Table 22). In Kentucky, state tax is not paid on Social Security income or the first \$35,000 of private pension income. The net result is that the majority of individuals drawing Social Security or pension income pay no state income tax. Moreover, since the labor force participation rate declines with age (see Figure 39),¹²⁸ the local occupational tax will be affected as the population ages.

¹²⁷ This is an estimate for 1999. The data were downloaded from the U.S. Census Bureau <<http://www.census.gov/govs/estimate/9918ky.html>>.

¹²⁸ Howard N. Fullerton, Jr., "Labor force participation: 75 years of change, 1950-98 and 1998-2025," *Monthly Labor Review*, December 1999, 24 October 2001 <<http://www.bls.gov/opub/mlr/1999/12/art1full.pdf>>.

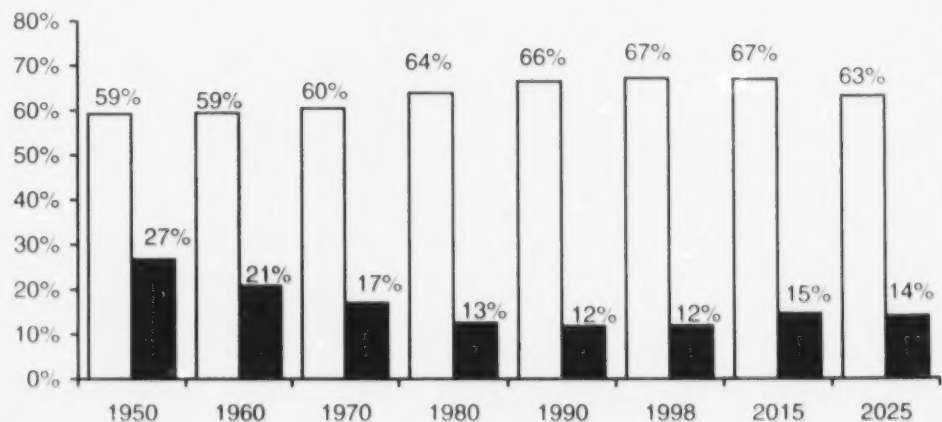
TABLE 22
Older Citizens Receive a Much Larger Portion
of Their Income from Social Security and Pensions

Age Group	<25	25-34	35-44	45-54	55-64	65 and older
Money income before taxes (total)	\$18,856	\$37,946	\$47,356	\$53,131	\$43,770	\$24,451
Wages and salaries	16,613	35,212	43,098	46,695	30,749	4,471
Self-employment income	245	1,489	2,062	3,175	3,447	1,173
Social Security, private and government retirement	73*	260	775	1,868	7,571	16,558
Interest, dividends, rental income, other property income	328	150	387	535	1,082	1,840
Unemployment and workers' compensation, veterans benefits	149	143	131	199	274	70
Public assistance, supplemental security income, food stamps	246	282	309	228	306	200
Regular contributions for support	770	244	483	188	220	82
Other income	432	168	111	243	120	57

Source: Average annual expenditures and characteristics, South, by Age Group, Consumer Expenditure Survey, 1998-1999.

*Data are likely to have large sampling errors.

FIGURE 39
Civilian Labor Force Participation Rates by Age,
1950-1998, and Projected, 2015-2025



Source: Bureau of Labor Statistics

□ Total, 16 and older ■ 65 and older

PROPERTY TAX

The property tax is the third largest source of Kentucky's *combined* state and local tax revenue, accounting for around 17 percent.¹²⁹ In reality, it constitutes a small portion of state tax revenue, around 5 percent, and a large part of local tax revenue, just over 50 percent. As we have already discussed, the Homestead Exemption on real estate for the 2001 and 2002 tax years now exempts from taxation the first \$26,800 of a property's assessed value for property owners who are at least 65 years old. As the population ages and more citizens become eligible for the exemption, the property tax burden will gradually shift to other property owners. Moreover, local governments will be likely to seek other revenue sources, such as the occupational tax and insurance premium taxes.

COST IMPLICATIONS OF AN AGING POPULATION

For a variety of reasons, the elderly pay less tax (see Table 23) and as their ranks increase, state and local government will see the impact on revenue receipts. At the same time, the aging population is expected to exert increased, reciprocal pressure on the expenditures side of the ledger.

TABLE 23
Older Citizens Pay Less State and Local Tax
as a Percentage of Their Total Income

	Under 25	25 to 34	35 to 44	45 to 54	55 to 64	65 and older
Money income before taxes	\$18,856	\$37,946	\$47,356	\$53,131	\$43,770	\$24,451
Federal income taxes	562	1,997	2,725	3,445	2,166	573
State and local income taxes	123	371	508	585	416	58
Other taxes	14	47	125	185	225	209

Note. **Money income before taxes** is the total money earnings and selected money receipts during the 12 months prior to the interview date for the consumer expenditure survey. It includes the following components: wages and salaries; self-employment income; Social Security; private and government retirement; interest; dividends; rental income; and other property income; unemployment and workers' compensation and veterans' benefits; public assistance; supplemental security income; and food stamps; regular contributions for support; and other income.

Federal income taxes includes federal income taxes withheld in survey year to pay for income earned in survey year plus additional taxes paid in survey year to cover any underpayment or underwithholding of taxes in the year prior to the survey.

State and local income taxes includes state and local income taxes withheld in survey year to pay for income earned in survey year plus additional taxes paid in survey year to cover any underpayment or underwithholding of taxes in year prior to survey.

Other taxes includes personal property and other personal taxes paid, including Social Security taxes for the self-employed paid in the survey year to cover any underpayment or underwithholding of taxes in the year prior to the survey.

Refer to <http://www.bls.gov/cex/csxgloss.htm> for additional information.

Source: *Average annual expenditures and characteristics, South, by Age Group, Consumer Expenditure Survey, 1996-1999*.

The projected growth in spending on Medicare, Medicaid, and Social Security dominates the long-term federal budget outlook. If current policies at the federal level remain the same, spending on these three programs is likely to grow significantly faster than the economy as a whole over the next few decades. By 2040, the Congressional Budget Office (CBO) projects, spending on these three programs could account for about 17 percent of gross domestic product (GDP), which is more than double the current 8 percent.¹³⁰ And if proposals to increase benefits in

¹²⁹ This is an estimate for 1999 using data from the U.S. Census web site.

¹³⁰ Congressional Budget Office (CBO), *The Long-Term Budget Outlook* (Washington: Author, Oct. 2000), CBO Web site, 25 October 2000 <<http://www.cbo.gov>>.

any of these programs are adopted, spending will grow even more rapidly, which will result in an even greater share of the gross domestic product going to these programs.

Anticipated increases in health and retirement spending are due to three factors. First, as the Baby Boom generation retires, expenditures for Social Security and Medicare will increase considerably simply by virtue of the increase in numbers of recipients. Second, Americans are living longer and spending more time in retirement, thus increasing the time during which they are dependent upon these programs. Third, the cost of health care is expected to continue rising steadily and thus increasing costs for Medicare and Medicaid.

Moreover, the demographic changes projected over the coming decades will significantly alter the ratio between retirees and workers and thereby affect both sides of the federal, state, and local government's budgetary ledger. According to CBO, "In 1960, 5.1 workers supported each beneficiary in the Social Security Program; today, the ratio is about 3.4 to 1, and in 2040, it is projected to fall to just 2.1 workers per beneficiary."¹³¹ Consequently, the growth of federal outlays for Social Security and Medicare will increase rapidly while the *growth* of revenues from taxes that largely fund these programs will slow.

Kentucky's older population, which is expected to be larger than that of many states, will almost certainly increase demand for public services at the state and local as well as the federal levels. A significant portion of the cost of Medicaid, three quarters of which is spent on nursing home or adult day care for older recipients, is paid for by the Commonwealth. Indeed, Medicaid has been the fastest rising public cost in the state of Kentucky for a number of years. Moreover, Kentucky's older citizens have historically been disproportionately poor and thus more likely to rely heavily on a combination of federal and state programs for support. We also know that a significant percentage of Kentuckians will depend on Medicare and Social Security in their retirement.

In a collaborative project with the University of Kentucky Sanders-Brown Center on Aging, the Kentucky Long-Term Policy Research Center has surveyed Kentucky citizens 45 years old and older to determine the extent of their current and anticipated reliance on these programs.¹³² We find that respondents rely or plan to rely heavily on Medicare for health care in retirement; 76 percent say it is or will be a major source of health care (see Table 24).¹³³ If Medicare provisions remain unchanged, this portends fiscal strain on state Medicaid budgets, as Medicare provides limited coverage of nursing home care, and employer-provided health care, which 43 percent of respondents say is or will be a major source of their health care in retirement, may not provide long-term care coverage.

¹³¹ CBO, *The Long-Term Budget Outlook*.

¹³² Refer to Michal Smith-Mello, et al., *Challenges for the New Century* (Frankfort: Kentucky Long-Term Policy Research Center). Appendix E for information about the Kentucky Retirement Survey.

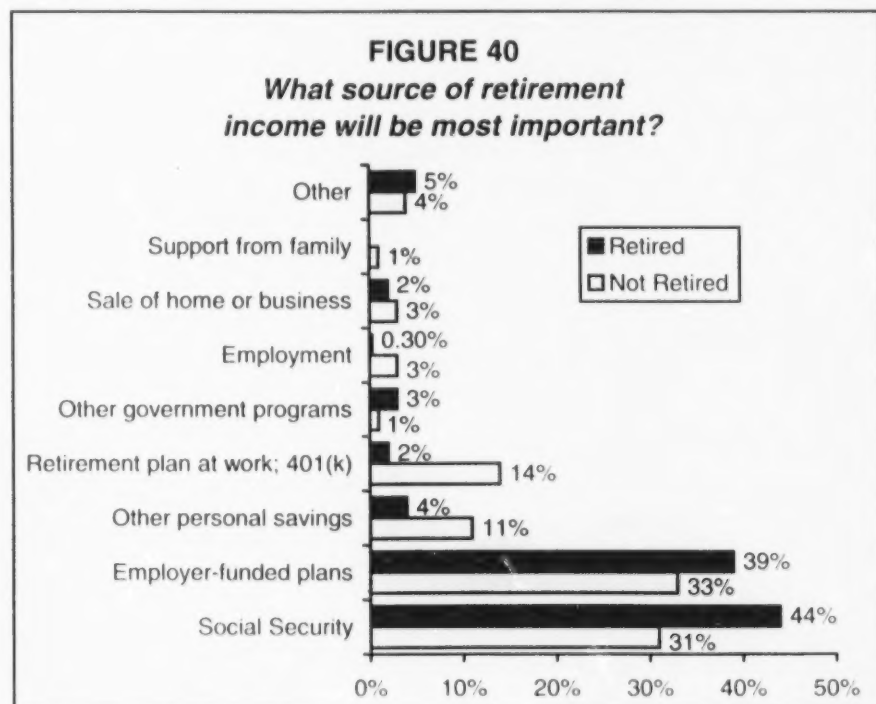
¹³³ Michal Smith-Mello and Amy Watts, "Anticipating Future Needs for Long-Term Care," *Policy Notes*, Kentucky Long-Term Policy Research Center, Frankfort, No. 4, June 2001.

TABLE 24
Current and Anticipated Sources of Health Care in Retirement for Kentuckians Ages 45 and Older, 2000

	Major Source	Minor Source	Not a Source
Employer-Provided	43%	10%	47%
Medicare	76	16	8
Medicaid	33	15	53
Medicare Supplement	47	25	28
Support from Children/Family	1	4	95
Charitable Foundations	1	2	97
Long-Term Care Insurance	9	7	84
Other*	17	3	79

Source: Kentucky Long-Term Policy Research Center, UK Sanders-Brown Center on Aging, UK Survey Research Center

Concerning Social Security, a significant percentage of Kentucky's retirees list it as the most important source of their retirement income (44 percent), and about one third (31 percent) of those not yet retired believe Social Security will be the most important source of income in their retirement (see Figure 40).¹³⁴



What is true in Kentucky is true across the country: current and future retirees will depend heavily upon Medicaid, Medicare, and Social Security. The heavy reliance many Americans have and will have on these programs will cause their

¹³⁴ Michael T. Childress, "Are Kentuckians Financially Prepared for Retirement?" *Policy Notes*, Kentucky Long-Term Policy Research Center, Frankfort, No. 5, Aug. 2001.

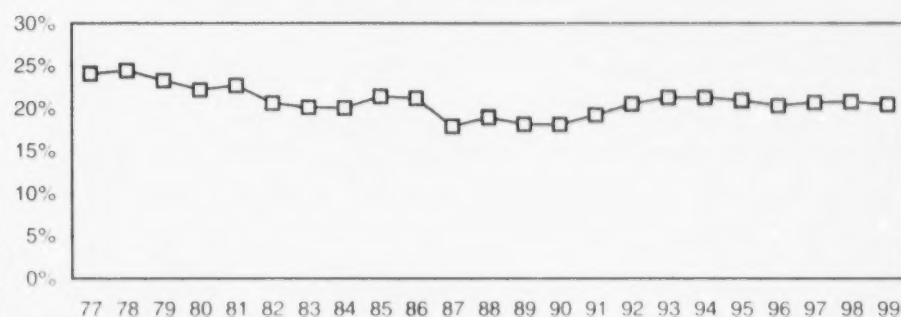
aggregate share of the budgetary pie to increase substantially as the Baby Boomers retire.

MORE HEAVY LIFTING FOR STATE AND LOCAL GOVERNMENTS

Many economists believe the increased burden the Baby Boomers will place on the federal government will in turn create a heavier burden for state and local governments.¹³⁵ According to C. Eugene Steuerle, an economist with the Urban Institute who recently chaired the Technical Panel advising the Social Security Administration on its methods and assumptions, "There will be extraordinary pressure upon states and localities to self-finance much of what they want to do in the near future."

According to the National Association of State Budget Officers (NASBO), "The share of total state spending financed by federal funds declined from 26.3 percent in fiscal 1996 to 25.8 percent in fiscal 1997. Federal aid to states is expected to continue on a downward trend for the foreseeable future."¹³⁶ Indeed, the percentage decreased to 25.2 percent in fiscal year 1999.¹³⁷ From the combined state and local government perspective in Kentucky, federal funds account for about 20 percent of total expenditures (see Figure 41), which is a significant amount. As Baby Boomers begin to retire in large, it is quite likely that intergovernmental transfers from the federal government to state and local governments will decline. This means, of course, that the state's financial burden could become heavier in the future. In turn, it is likely that governments will look increasingly at its system of state and local taxation to ensure it will have sufficient revenue to provide expected services.

FIGURE 41
Federal Funds as a Percentage of Kentucky
State and Local Expenditures, 1977-1999



Source: US Census Bureau, *Census of Governments*

¹³⁵ C. Eugene Steuerle, untitled speech, Kentucky Long-Term Policy Research Center Annual Conference, "Challenge for the Next Century," Covington, Kentucky, 14 Nov. 2000.

¹³⁶ National Association of State Budget Officers (NASBO), NASBO web site, 7 Nov. 1998, 19 Nov. 2000 <<http://www.nasbo.org/pubs/exp rpt/serexec.htm>>.

¹³⁷ NASBO.

CONCLUSION

States that disproportionately depend on the sales tax or the income tax for general fund receipts are likely to feel the effects of structural changes underway in the economy and population sooner than most. For example, Tennessee and Washington are highly dependent on the sales tax while Oregon and Maryland rely heavily on the personal income and occupational tax. Kentucky, on the other hand, is not "overly dependent" (relatively speaking) on any *one* tax source. Yet Kentucky's percentage of state and local tax revenue from the general sales tax, selective sales tax, and individual income tax is 68.9 percent (see Table 25), the fifth highest percentage in a ranking of all states and well above the U.S. average of 57.7 percent. This suggests that Kentucky's state and local tax system will begin to feel the effect of these long-term structural changes in the economy and population before many other states.

TABLE 25
Percent of State and Local Tax Revenue by Tax Source, 1997

	General Sales Tax	Selective Sales Taxes*	Property Tax	Individual Income Tax	Corporate Income Tax	Other Taxes
KY	21.2	16.5	17.2	31.2	3.3	10.6
US Total	24.5	11.4	30.0	21.8	4.6	7.6

*Selective sales taxes include: alcoholic beverage taxes, amusement taxes, insurance premiums taxes, motor fuels taxes, pari-mutuels taxes, public utilities taxes, tobacco sales taxes, and other selective sales taxes.

Source: Calculations by author using US Census Bureau data on state and local finances.

8

TAX REFORM

Review and Perspective

By Merl Hackbart*

While acknowledging that numerous efforts in the name of "reform" have fostered cynicism and undermined the credibility of new undertakings to modernize the Commonwealth's tax structure, this chapter reviews notable 20th century reforms to Kentucky's tax system, their impetus, and their effects. It then turns to an examination of the trends that have emerged from tax reform efforts in other states during the 1990s and concludes with observations about the implications for comprehensive versus incremental change in Kentucky's tax system.

Tax reform has been the focus of numerous study groups and commissions, gubernatorial initiatives, and legislative actions in Kentucky and the 50 states over the past several decades. The goals and content of tax reform initiatives change over time reflecting different economic and demographic conditions, intergovernmental tax environments, and other factors. The success or failure of tax reform efforts depends on a number of factors including public understanding of the reform issues, the commitment of policymakers to the reform effort, and supporting "drivers" or trends and events which enhance the possibility of reform. This chapter provides a historical perspective of tax changes and reform efforts in Kentucky since 1930 along with a review of tax changes in the other states during the past decade. The review of Kentucky tax reform efforts considers the types of tax changes that have occurred, the circumstances surrounding such changes and their implications for future tax reform initiatives. The analysis of tax changes in the other 50 states includes a summary of the changes enacted regarding the three major state taxes (personal income, sales, and



* The author acknowledges the excellent research support of Suzanne Perkins, Graduate Research Assistant at the Martin School of Public Policy and Administration, University of Kentucky.

corporate income) including rate changes, base changes, and administrative adjustments. By reviewing Kentucky's tax reform history and more recent tax law changes in the other states, insights regarding tax reform trends and factors influencing comprehensive and incremental tax reforms may be found. In turn, such insights might support future tax reform efforts in the Commonwealth.

As suggested, tax reform has been on Kentucky's public policy agenda for decades. In response to changes in Kentucky's economy, demographics, income, expenditure needs, federal tax policy changes, and other factors, Governors, Special Tax Task Forces or Tax Study Commissions, and members of the Kentucky General Assembly have proposed tax changes that have often been described as "tax reforms." The enacted "reforms" have eliminated taxes, introduced new taxes, increased and decreased tax rates, expanded or contracted tax bases, and changed administrative processes regarding the assessment and collection of Kentucky taxes. The various tax reform initiatives have adjusted tax burdens for segments of Kentucky's taxpaying population and modified Kentucky's competitive position, taxwise, relative to neighboring states.

While changing economic, demographic, and fiscal trends in Kentucky may have created conditions that called for comprehensive tax reform, broad-based reform has occurred infrequently during the last century. When major restructuring or "comprehensive reform" did occur, reform efforts were often supported by "drivers" or "triggering events" such as a court decision, a state fiscal crisis, or the emergence of broad public concern regarding the fairness of a specific tax. Meanwhile, incremental tax changes have occurred frequently and have often been driven by intensive lobbying by special interests, efforts to align state taxes with changes in federal tax laws, and national tax reform "waves" regarding individual taxes such as the property tax limitation that swept across the nation in the 1970s.

TAX REFORMS OR JUST TAX CODE CHANGES?

As suggested, whether initiated by members of the legislative branch, the Governor or interest groups, tax changes are often proposed as "tax reforms." The term "tax reform" is often used by tax change advocates whether or not the proposed tax changes enhance a state's tax structure relative to accepted tax principles. Apparently, the term "reform" is attached to tax initiatives to make the proposed adjustments more acceptable. Consequently, the term "tax reform" has been attached to legislation that enhanced state tax structures relative to "good tax principles" as well as tax changes that have narrowed state tax bases, enhanced complexity, reduced state tax equity (horizontally or vertically), and reduced the adequacy of state tax systems. The latter tax changes marketed with the "tax reform" label have limited opportunities for enacting true state tax reform legislation.

In other words, the indiscriminant use of the term "tax reform" has fostered credibility problems for true tax reform efforts in recent years. The public and the

press often perceive that tax changes proposed in the name of reform do not, necessarily, mean that proposed changes will produce a tax code that is more equitable, simpler, more neutral, more competitive, or more adequate—the traditional goals of “true” tax reform legislation. This credibility problem has enhanced cynicism about tax reform and has made meaningful tax reform efforts more difficult.

COMPREHENSIVE REFORM IN THE 20TH CENTURY

While cynicism may present an obstacle to true, comprehensive reform, there are cases in Kentucky's history when reform initiatives have produced meaningful, tax-principle-based changes in Kentucky's tax structure. For example, tax changes in the mid 1930s, 1960, the early 1970s, and 1990, were based on one or more of the accepted tax principles (the principles of adequacy, simplicity, equity or fairness, neutrality, and competitiveness). It should be noted that while these successful reform efforts were based, in part, on accepted tax principles, their ultimate passage was facilitated by the support of “reform drivers.” Among the drivers were broad-based public concerns about the fairness of Kentucky's tax structure (1930s and perhaps 1960), legislative and executive branch efforts to focus public opinion on a tax reform issue (1960 and early 1970s), or the intervention of the courts regarding a related policy issue such as the adequacy of Kentucky's education financial support in the 1989 Supreme Court case (1990). These major or comprehensive reform initiatives are reviewed in sections that follow to indicate the types of tax reforms that were enacted and the forces or drivers that enhanced the potential for major tax reform success.

Other tax changes of the century tended to be incremental. Some of Kentucky's incremental changes involved tax-principle-based reform while other changes involved special tax changes supported by groups of individuals, businesses, or “special interests.” Some of the latter incremental changes were passed with minimal focus on their broader tax policy implications. Still, such special tax legislation was often considered “reform” by its advocates whether the change was true reform or simply involved special benefits for certain taxpayer groups. Some of Kentucky's incremental reforms and changes are also cited below.

THE REFORM INITIATIVES OF THE 1930S

Changing economic conditions and the financial crisis of the depression led to the enactment of a gross receipts tax in 1934 to modify the state's historical reliance on the property tax as its main source of revenue. Studies¹³⁸ indicate that 60 to 70 percent of Kentucky's revenue came from property taxes between 1830 and the 1920s with the remainder coming from a variety of minor sources such as special fees and licenses. However, in the 1930s, the economic downturn reduced state revenues and raised concerns about the state's heavy dependence on the property tax for financial adequacy and equity reasons. The property tax was the main

¹³⁸ Kentucky Department of Revenue Report, 1950 and others.

source of state revenue even though property was no longer the principal source of wealth. Tax policy reform advocates indicated that changes in the economy had made wages, salaries, profits, and dividends equivalent sources of income and wealth (to property) and that a tax system based on property taxes was no longer equitable or reflective of ability to pay. As a result, there was public clamoring for change in the state's tax system. In response to public concern, a 3 percent gross receipts tax was enacted in 1934 and the property tax was reduced to a nominal rate of five cents per \$100.¹³⁹

After the enactment of the 1934 gross receipts tax, administrative problems and perceived regressivity made the gross receipts tax extremely unpopular. Public concern regarding the tax focused on its differential impact on different sectors and its perceived burden on lower income groups. As a consequence, the tax was repealed and replaced by Kentucky's first personal and corporate income taxes along with a system of "selected" sales taxes on alcoholic beverages, cigarettes, amusements, and utility receipts in 1936.¹⁴⁰

The comprehensive reform and modernization initiatives of the 1930s were followed by a period of relative tax structure stability until the 1960s. Exceptions were the enactment of a pari-mutuel tax in 1948, modest changes in tax rates for the income and corporate taxes in 1950 and incremental adjustments to other tax and fee structures. Kentucky also passed legislation in 1954 that made Kentucky the fourth state to have an income tax withholding system. In the same period, Kentucky adopted the federal definition of net income with minor exceptions.¹⁴¹

THE 1960 REFORM LEGISLATION

In the 1960 session of the Kentucky General Assembly, Kentucky became the 34th state to enact a sales and use tax. A 3 percent tax was imposed on the "privilege of making retail sales in Kentucky." The tax, part of Governor Combs' education initiative, was broad-based and applied to all tangible personal property sales. The imposition of the sales and use tax, along with changes in the income tax, fundamentally altered the structure of Kentucky's general fund tax base. As a result of that legislation, the sales tax produced almost half of the state's general fund revenue (48 percent) compared with 21 percent for the previous year when the state had a selective sales tax structure enacted in 1936. Income taxes (individual and corporate) that had produced 50 percent of state revenues now contributed only 33 percent of total general fund revenues. The enactment of the broad-based sales tax in 1960 was followed by a rate increase to 5 percent in 1968. With that increase, the dominance of the sales tax as Kentucky's principal revenue source increased from 50 percent of General Fund receipts in FY 1968 to 59 percent in FY 1969 while income taxes provided 29 percent of total FY 1969 revenues. It is noted that the Kentucky legislature began narrowing the sales tax base in 1966—a mere 6 years after the enactment of Kentucky's first broad-based sales tax.¹⁴²

¹³⁹ Ky. Dept. of Revenue.

¹⁴⁰ Ky. Dept. of Revenue report, 1950.

¹⁴¹ Ky. Dept. of Revenue reports, various 1950-1960.

¹⁴² Ky. Dept. of Revenue report, 1959-60 and others 1960-1970.

1970-1972 REFORM EFFORTS

The reform efforts of 1970 and 1972 focused on equity issues associated with the sales tax. It was, apparently, assumed that the taxation of food and prescription drugs imposed an inequitable burden on lower-income Kentucky taxpayers and that the elimination of these taxes provided a fairer tax structure. As a result, in 1970, prescription drugs were exempted from the sales tax along with a series of minor tax code changes. Food was added to the exemption list in 1972. To replace the revenue loss associated with the food sales tax exemption (13 percent of general fund revenues), a severance tax was also passed during the same session. The severance tax legislation imposed a 4 percent tax on the gross value of coal mined, or 30 cents per ton, whichever was greater. The tax rate was raised to 4.5 percent or 50 cents per ton in 1976. It is noted that the food and prescription drug exemptions continued the trend of narrowing Kentucky's sales tax base which began in 1966—an example of the positive and negative tradeoffs which occur when tax reform initiatives are undertaken.¹⁴³

The sales tax exemptions and the enactment of the severance tax were the major changes in Kentucky's tax structure in the 1970s except for House Bill 44 (HB44) that was passed in 1979 by a special session of the Kentucky General Assembly called by Lieutenant Governor Thelma Stovall. The legislature initially struggled with the purpose of the call but eventually passed a property tax limitation bill. The bill, which continues to be referred to as HB44, was recognized as the Kentucky version of special property tax limitation legislation that swept the nation in the 1970s.

The property tax limitation wave that eventually passed through 20 states began in Iowa and became nationally prominent when California passed Proposition 13. The California initiative resulted from a growing concern over rapidly increasing state property taxes. The escalating California property taxes were driven by inflated property values that were not offset by lower tax rates. It is interesting to note that the property tax limitation wave impacted Kentucky even though Kentucky had significantly reduced its dependence on the property tax in the 1930s and was considered to be a low property tax state.

The 1979 legislation limited property tax growth to 4 percent per year (a combination of assessed value and rates) for state government. Local taxing districts were made subject to the same revenue limitations although the rules are different. For example, new property is not subject to the 4 percent property tax revenue growth lid for local governments. Combined with earlier adjustments to Kentucky's tax code, HB44 ensured that property taxes would remain a minor part of Kentucky's tax portfolio for decades to come.

Kentucky's tax structure, again, stabilized during the 1980s. The exception was a series of modifications to existing taxes enacted in the 1985 Extraordinary Session of the Kentucky General Assembly. Known as the Kentucky Equity Tax Act (KETA), the changes were principally enacted to provide funding for Governor Collins' Educational Improvement Act. KETA included a slight expansion of

¹⁴³ Ky. Dept. of Revenue annual reports, 1970-73.

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the sales tax base (to include rentals and leases), rate changes for the corporate income and license taxes, and revisions in Kentucky's depreciation schedules. In addition, business inventory taxes were reduced, the federally-based depreciation schedule was replaced by a separate Kentucky depreciation system, and the formula for apportioning business income and capital employed by multistate corporations was changed to allow double weighting of the sales factor and assigned equal weight for property and payroll factors. KETA also revised the inheritance tax to reflect changes in the economy, particularly inflation, and eliminated all inheritance taxes on property passing from the decedent to the surviving spouse.¹⁴⁴

THE 1990 KENTUCKY TAX REFORM

The 1990 session of the Kentucky General Assembly provided a unique opportunity for Kentucky to revise and adjust the structure of its revenue base. Under pressure from a 1989 Kentucky Supreme Court decision that declared Kentucky's system of elementary and secondary education unconstitutional, including its system of finance, the Governor and the General Assembly sought ways to reform and refinance Kentucky's education system.¹⁴⁵ The major refinancing issues involved providing sufficient revenue to meet the Court's concerns for school financing adequacy and reforming the state's system of distributing state school support to the state's school districts to achieve greater financing equity.

In a surprising initiative, Governor Wilkinson proposed a comprehensive tax reform program that would have raised taxes by approximately 18 percent and restructured the state's tax system in several dimensions. Governor Wilkinson's proposal included the following elements:

- The broadening of the sales tax base to include some services,
- The elimination of the deductibility of federal income tax payments,
- The enactment of a low income tax credit,
- An increase in the cigarette tax rate,
- An increase in the corporate tax rate, and
- An update of the Kentucky tax code to reflect changes in the Internal Revenue Service tax code.

Governor Wilkinson's proposal was designed, primarily, to provide additional revenue for Kentucky's elementary and secondary schools. It also, however, was designed to increase the progressivity of Kentucky's income tax by eliminating the deductibility of federal income taxes paid and the enactment of a low income tax credit. Limited progressivity gains were also anticipated from the broadening of the sales tax to include items and services more frequently consumed by higher income groups. The proposed broadening of the sales tax was also designed to reflect changes in the Kentucky economy which was experiencing a gradual shift from a focus on goods-producing sectors to a greater emphasis on service-related sectors. Meanwhile, the rate increases for the corporate and cigarette taxes were included for revenue enhancement reasons. Compliance with the federal tax code

¹⁴⁴ Ky. Dept. of Revenue annual reports, 1980-1989.

¹⁴⁵ *Rose vs. Council for Better Education, Inc.*

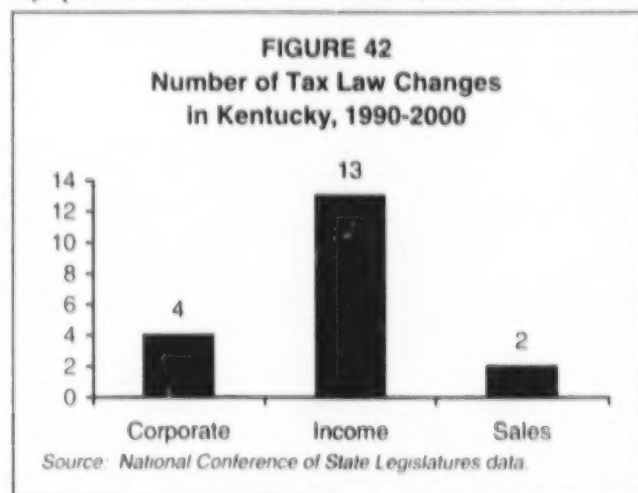
involved a periodic update of Kentucky's income tax code to reflect changes in the federal income tax.

After considerable debate and negotiations, the Kentucky General Assembly adopted a tax reform package that omitted two of Governor Wilkinson's tax proposals including the increase in the cigarette tax and the broadening of the sales tax. In order to produce equivalent revenue, the Kentucky General Assembly enacted a tax bill that increased the sales tax from 5 to 6 percent. While the increase in the sales tax provided additional revenue to meet educational finance needs, the benefits of a broadened sales tax base were not realized. Still, the 1990 tax legislation enhanced the progressivity of Kentucky's tax structure, dealt with the adequacy concerns of the Kentucky Supreme Court, and simplified portions of Kentucky's tax code.

After the major tax changes of the 1990 session, Kentucky returned to the national trend of enacting frequent incremental tax structure reforms. For example, House Bill 1 of the 1995 Extraordinary Session of the General Assembly called by Governor Jones exempted the first \$35,000 of income from private pensions and individual retirement accounts (IRAs) from Kentucky's personal income tax. The pension and IRA income exemptions were largely driven by public and private sector employee horizontal equity concerns. Those concerns arose after state government and educators' pension exemptions were extended to federal employees as a result of the *Davis vs. Michigan* case. That case found that special treatment of state employees vis-à-vis federal government employees regarding the tax exemption of pension funds was unconstitutional. In addition, legislation passed during the same session phased in an exemption for Class A beneficiaries from the inheritance tax over a four year period.

Figure 42 summarizes Kentucky's tax changes enacted during the 1990s by major tax. The reforms included 4 changes to the corporate income tax, 13 amendments to the Kentucky personal income tax statutes, and 2 sales tax changes.

The corporate tax amendments included an increase in the top corporate tax rate in 1990, a change in the date that interest is due on refunds for net operating loss (NOLs) carry-backs in 1992, a skills-training investment credit, and a Kentucky Investment Fund Tax Credit in 1998. The personal income tax changes are shown in Table 26 and include a variety of changes including the previously cited enactment of a low income tax credit in 1990 and an increase in the standard deduction during the 1996 legislative session among others. Sales tax "reforms" included the previously noted in-



crease in the top corporate tax rate in 1990 and an increase in the standard deduction during the 1996 legislative session among others. Sales tax "reforms" included the previously noted in-

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crease in the general sales tax from 5 to 6 percent in 1990 and a broadening of the industrial supply exemption in 1996.

TABLE 26
Kentucky Income Tax Changes in the 1990s

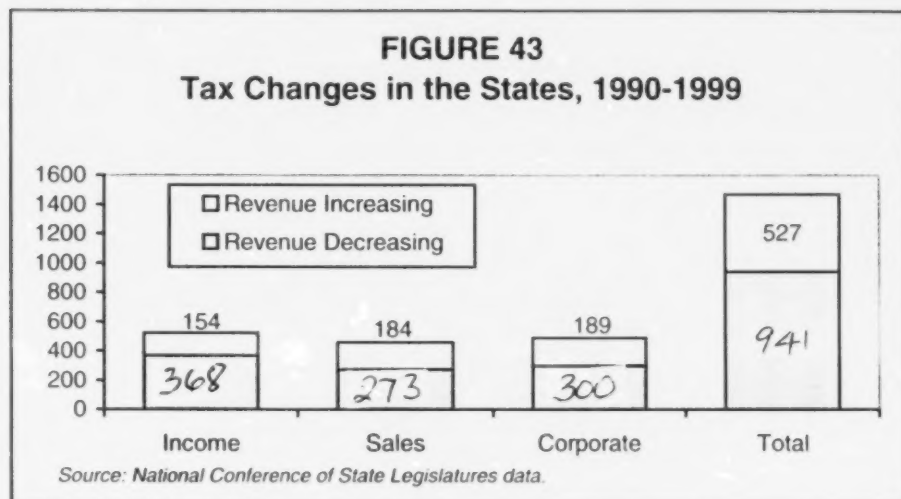
Type of Change	Year Enacted
1. Conformed to federal IRC provisions.	1990
2. Repealed automatic deduction of fed. income taxes paid.	1990
3. Enacted a low-income tax credit.	1990
4. Conformed to federal tax treatment of high income.	1992
5. Required taxpayers with > \$100,000 in liability to remit those funds immediately rather than on due date.	1994
6. Conformed to federal IRC provisions.	1994
7. Adopted 4 year phase-in of exclusion for private pensions and IRAs.	1995
8. Increased standard deductions.	1996
9. Continued phase-in of increases in standard deductions.	1997
10. Continued phase-in of increases in standard deductions.	1998
11. Adopted deduction equal to 70% of health insurance payments.	1998
12. Excluded capital gains from property taken by eminent domain.	1998
13. Conformed to federal IRC provisions.	2000

TAX CHANGES IN OTHER STATES

Like Kentucky, the other 49 states were actively engaged in modifying tax structures during the 1990s in response to changing economic and fiscal conditions and the pursuit of tax reform goals. This section provides an overview of the tax change trends regarding the three major state taxes during the 1990s including the personal income tax, the state sales tax, and the corporate income tax. The trend analysis benefited from data obtained from the National Council of State Legislatures (NCSL). The NCSL data are acquired annually from the 50 states and provide brief descriptions of tax legislation passed by the respective states. The data include information about whether the tax changes increased or decreased tax rates, expanded or reduced the base for a tax, and/or adjusted administrative processes associated with state taxes. It is noted that administrative process and rule changes such as changes in the definitions of items subject to the sales tax, accelerating the processing of tax returns by hiring more personnel, and allowing energy companies to transfer unusable tax benefits to other corporations and the like, can directly or indirectly impact state revenues. Unfortunately, the NCSL data do not provide information on the purposes or goals of the tax changes enacted by the states in the 1990s such as the enhancement of a state's tax structure adequacy, the simplification of a state's tax structure, and the like. Consequently, an analysis of state tax reform goal trends was not permitted. However,

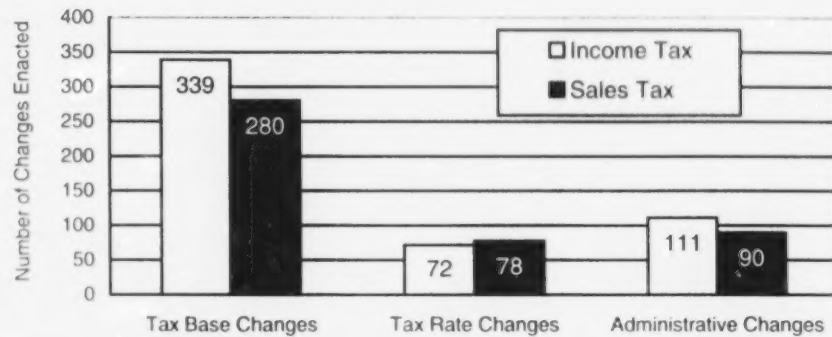
an assessment of major state tax changes during the 1990s provides useful perspectives on the state tax policy reform environment.

The NCSL data indicate that there were 489 corporate tax changes, 522 individual income tax code changes, and 457 sales tax changes enacted during the 10-year period from 1990 to 1999 (see Figure 43). The tax changes involved a variety of actions that increased or lowered the revenue yield of the respective state tax types. For example, 154 actions increased state income taxes while 368 legislative changes produced less state income tax revenue. Sales taxes had a similar pattern with 273 tax reductions and 184 tax increases. Meanwhile, 300 state corporate income tax changes involved tax decreases while 189 changes were anticipated to increase state corporate revenue.



In Figure 44, state personal income and sales taxes changes are broken into three categories including base changes, rate changes, and administrative process changes. As shown, base changes dominated sales and income tax changes during the decade, as 339 income tax base changes were enacted by the states while 72 rate and 111 administrative changes were passed. Similar patterns were found for the sales tax as 280 base changes were enacted; 78 rate changes and 90 administrative changes were legislated during the decade.

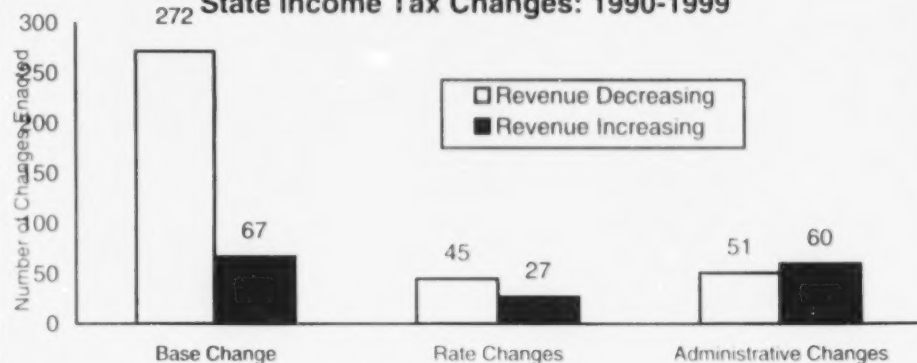
FIGURE 44
State Sales and Income Tax Changes,
by Type of Change: 1990-1999



Source: National Conference of State Legislatures data.

Tax legislative changes involving base, rate, or tax administration and procedures can increase or decrease revenue. Figure 45 indicates the revenue impact associated with the various state income tax adjustments made during the 1990s. As shown, revenue reductions dominated the state income tax base and rate changes made during the period as 272 base amendments decreased revenue compared to 67 base changes that enhanced revenue. Rate changes reducing revenue exceeded rate change increases by 46 to 27. Meanwhile, income tax administrative revisions increased revenue more often than they decreased state revenues (60 changes increased revenue while 51 administrative process changes decreased state income tax revenues).

FIGURE 45
State Income Tax Changes: 1990-1999



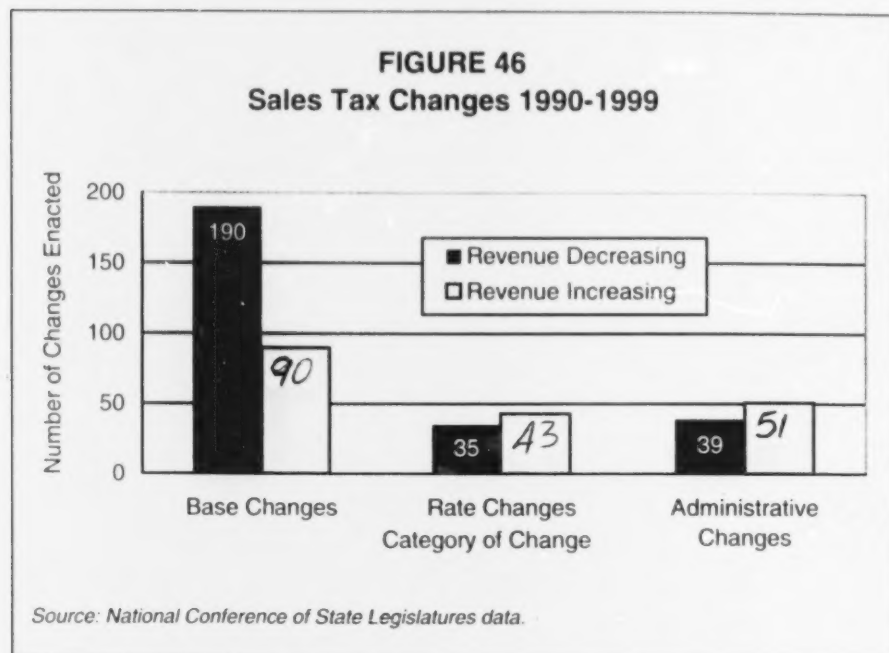
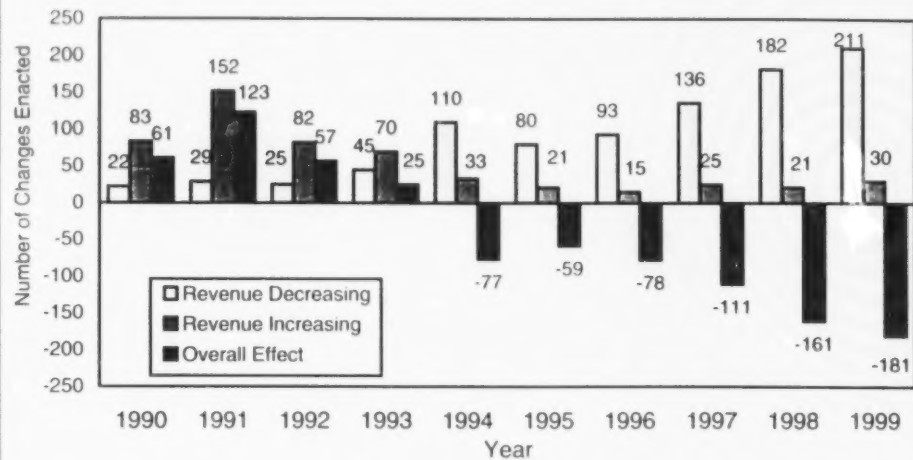


Figure 46 indicates a similar pattern of state tax reducing actions for the sales tax. As shown, legislation passed regarding sales taxes resulted in 264 reductions in sales tax revenue while 184 changes increased state revenues. However, analysis of tax modifications by category of change (base, rate, and administrative changes) provides a slightly different picture. For instance, 190 base-narrowing actions, including special exemptions among others, were enacted while 90 sales tax-broadening initiatives were enacted. However, sales tax rate changes resulting in increased state revenues exceeded sales tax rate reductions by a margin of 43 to 35 while administrative changes increased revenue 51 times compared to 39 actions which reduced state sales tax proceeds.

While revenue-reducing actions, regarding the state's three major taxes, dominated state tax changes in the 1990s, other trends are apparent. Figure 46 indicates overall trends regarding these state taxes for the period in terms of the number of reforms or changes. For example, tax increase actions (via rate, base, or administrative change) exceeded tax reduction actions, overall, from 1990 until 1993. This was, of course, a period in which states were witnessing slow state revenue growth. Apparently, to acquire needed revenues, tax revenue-raising measures were the dominant state tax policy. By contrast, from 1994 through the remainder of the decade, tax measures designed to reduce state revenues exceeded actions designed to increase state revenues. Figure 47 also indicates that state tax change frequency increased during the last half of the decade as state incomes increased and fiscal conditions improved.

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FIGURE 47
State Major Tax Increases, Decreases, and
Net or "Overall" Changes: 1990-1999



Source: National Conference of State Legislatures data.

OBSERVATIONS

This chapter has presented a brief overview of Kentucky's tax change and/or reform history. It was observed that comprehensive or major restructuring of Kentucky's tax base has occurred infrequently during the past century. Four periods were highlighted as times when analysts might conclude that comprehensive reform was accomplished. It was further suggested that the major reforms had identifiable drivers such as broad-based taxpayer concern regarding the existing tax structure, court cases, strong executive and/or legislative leadership, or the state was facing major fiscal problems and economic challenges. In the intervening periods, tax policy in Kentucky has been dominated by change or reform initiatives that could be classified as incremental or marginal changes. The drivers for those changes tended to be particular interest groups uniquely impacted by a tax or special efforts by executive or legislative branch officials who focused on a specific tax equity, simplicity, or tax competition problem. These small or marginal changes occurred frequently over the past several decades. Unfortunately, some of the marginal changes were enacted with little consideration of their impact on the overall fairness, neutrality, simplicity, adequacy, or competitiveness of the Kentucky tax structure.

From this review, it appears that Kentucky is like most states in its approach to tax policy matters. State tax changes enacted in the 1990s suggest a return to the tendency to mirror or "emulate" tax initiatives of other states, while simultane-

ously adjusting taxes to deal with state specific issues. The tendency to emulate actions of other states included, historically, the wave of property tax limitation legislation that spread across the country in the 1970s. For the 1990s, national "emulation" trends included both tax increases (the first part of the 1990s) and tax reductions (during the latter part of the decade).

Another characteristic of state tax policy suggested by the NCSL data is the tendency for states to enact incremental rather than major or comprehensive tax reforms. In the absence of overriding reasons for major reform, states have tended to enact frequent marginal changes in rates, bases, or administrative processes. In other words, when drivers for major change are not present such as court decisions, declining fiscal conditions, or special needs, incremental change tends to dominate state tax policy.

Perhaps, in the absence of major fiscal issues or taxpayer concerns, state tax policymakers prefer to revise state tax structures incrementally so that changes in state revenues are small and tax policy impacts on taxpaying groups are marginal. With small changes, state revenue and tax impacts may be easier to determine and fluctuations in state revenue streams from the direct and behavioral impacts of tax changes may be limited. The tendency for incremental or gradual tax policy change does not necessarily doom comprehensive state tax reform. Rather, it may suggest that comprehensive reform may have a greater chance for success, absent a major "driving force or event," if reform goals are set and incremental changes toward those goals are enacted over time.

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